AUDITOR INDEPENDENCE – AN ANALYSIS OF THE ADEQUACY OF SELECTED PROVISIONS IN CLERP 9

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Submitted in fulfilment of the requirements for the degree of
Doctor of Juridical Science

School of Law
Faculty of Law
Queensland University of Technology
August, 2014

Keywords

ASIC, auditor, auditor independence, CALDB, CLERP 9, corporations law, FRC, independence, legal reform, private interest theory and public interest.

Abstract

Worldwide corporate collapses in the past highlighted various weaknesses in the corporate governance regimes which included auditor independence. The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth) referred to as CLERP 9 was the Australian government's response to address the lack of auditor independence in Australia.

This thesis provides recommendations for practical legal reform where CLERP 9 is found to serve private interests rather than the public interest. This study advocates the use of private interest theory as an alternative method by which legal proposals in relation to auditor independence can be evaluated.

The proposal for this project is that the law relevant to audit independence was developed to serve private interests rather than the stated goal of the public interest, and as a result, the current regime is in need of reform. Through the use of private interest theory, this study critically evaluates the development of CLERP 9. The study explores (as far as auditor independence is concerned) whether the development of CLERP 9 has been motivated by the self-seeking interests of various interest groups rather than the public interest.

The findings from this study support the proposal of this thesis that there is a case for reform of the existing requirements in the *Corporations Act 2001* (Cth) as a result of CLERP 9 in respect of independence. This is because the law in some instances has been developed to serve private interests rather than the public interest and has, therefore, benefited the various interest groups at the expense of greater auditor independence (the public interest).

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List of Abbreviations

AARF	Australian Accounting Research Foundation
AASB	Auditing & Assurance Standards Board
ACCI	Australian Chamber of Commerce and Industry
Accounting Associations	The members of the Australian accounting professional bodies comprising of the CPA, the Institute and the IPA (formerly known as the 'National Institute of Accountants')
ACSI	Australian Council of Super Investors Inc
AICD	Australian Institute of Company Directors
AICPA	American Institute of Certified Public Accountants
APESB	Accounting Professional & Ethical Standards Board Limited
APPC	Australian Public Policy Committee
ASA	Australian accounting standards
ASFA	Association of Superannuation Funds of Australia Ltd
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001* (Cth)
ASX	Australian Securities Exchange Ltd (formerly known as the Australian Stock Exchange Ltd)
ASX Corporate Governance Principles	Revised principles and recommendations released by the Council
Audit Enhancement Act	*Corporations Legislation Amendment (Audit Enhancement) Act 2012* (Cth)
Audit Enhancement Bill	*Corporations Legislation Amendment (Audit Enhancement) Bill 2012* (Cth)
Avastra	Avastra Limited
BCA	Business Council of Australia
BDO	BDO Chartered Accountants and Advisers
CALDB	Companies Auditors and Liquidators Disciplinary Board
CAMAC	Corporations and Markets Advisory Committee
CLERP	Corporate Law Economic Reform Program
CLERP 9	*Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth)
CLERP 9 Bill	*Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003* (Cth)
Cameron	Cameron, DG
Compostela	Compostela Pty Limited
Corporations Act	*Corporations Act 2001* (Cth)
Council	ASX Corporate Governance Council
CPA	CPA Australia
CSR	CSR Ltd
current regime	CLERP 9
Deloitte	Deloitte Touche Tohmatsu
EQCR	Engagement quality control reviewer
External	The external commentators that had presented submissions

Commentators	in relation to the Relevant Proposals include the Attorney General for Victoria, Australian Auditors-General and The Institute of Internal Auditors.
EY	Ernst & Young
F1	Professional Statement F1 *Professional Independence*
FASB	Financial Accounting Standards Board
Finsia	Financial Services Institute of Australasia
FRC	Financial Reporting Council
FSC	Financial Services Council
FSU	Finance Sector Union of Australia
G100	Group of 100 Inc
GI	Governance Institute of Australia
GT	Grant Thornton
Harding	Harding & Associates
IAG	Insurance Australia Group Limited
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IBSA	International Banks and Securities Association of Australia
IFAC	International Federation of Accountants
IFAC Code	Code of Ethics for the IFAC
Institute	Chartered Accountants Australia and New Zealand (formerly Institute of Chartered Accountants in Australia)
IPA	Institute of Public Accountants
Joint Submission	Joint submission by PP, BDO, William Buck, GT and Horwarth Australia to the Treasury
JPCCFS	Joint Parliamentary Committee on Corporations and Financial Services
KPMG	KPMG Australia
Legal Practitioners	The legal practitioners that had presented submissions in relation to the Relevant Proposals include Allens Arthur Robinson, Corrs Chambers Westgarth, Law Council of Australia, Freehills Pty Ltd, Maurice Blackburn Cashman Lawyers and The Law Society of South Australia
MAS	Management advisory services
MCR	European Union Merger Control Regulation
MTF	European Union Merger Task Force
PKF	PKF Australia Limited and PKF Chartered Accountants & Business Advisers
PP	Pitcher Partners
PSCSB	Public Sector & Commonwealth Superannuation Boards
PSCSS	Public Sector & Commonwealth Superannuation Schemes, the Catholic Super Fund and the Northern Territory Public Authorities Superannuation Scheme
Public Investors	The public investors that had presented submissions in relation to the Relevant Proposals include the Australian Shareholders' Association Ltd and The Australian Workers' Union
PWC	PricewaterhouseCoopers
Ramsay Report	Professor Ian Ramsay's report, titled 'Independence of

	Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform', to the Australian government in October 2001
Relevant Proposals	Proposals for auditor independence law reform contained in the Australian government's discussion paper, titled 'Corporate Disclosure: Strengthening the Financial Reporting Framework' released to the public in September 2002
Sarbanes-Oxley Act	*Public Company Accounting Reform and Investor Protection Act*, Pub L No 107-204, 116 Stat 745 (2002)
SEC	Securities and Exchange Commission in the United States of America
Selected Interest Groups	The major interest groups selected to be analyzed in this thesis are the members of accounting professional bodies (comprising of the Big 4 Firms, Middle Tier Firms and Small Firms), managers of companies, government officials (comprising of the APESB, ASIC, ASX, AASB, CALDB and FRC)
Stockford	Stockford Accounting Services Pty Ltd
TCA	Trustee Corporations Associations of Australia
Telstra	Telstra Ltd
Treasury	The Department of Treasury, Australia

Statement of Original Authorship

The work contained in this thesis has not been previously submitted to meet requirements for an award at this or any other higher education institution. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made.

QUT Verified Signature

Signature:

Date: 29 August 2014

Acknowledgements

I would like to express my sincerest gratitude to my Principal Supervisor, Associate Professor Dr Colin Anderson for his insight, direction and guidance throughout the course, to my Associate Supervisor, Catherine Brown, for her extremely helpful support, assistance and comments to completion of this task and to Professor Dr Justin O'Brien for his valuable input at the early stage of my candidature.

I would like to acknowledge my late father, Dr Kim Hock Kuan, for whom without his support and encouragement, I would not have come this far and my mother, Evelyn Poh Sim Tan, for her sacrifice and love throughout these years and for providing me with the resources to complete this endeavour.

Thank you Huey Yee, my lovely wife, for your patience, support and for standing by me.

To my daughter Kelly Xin Huei Kuan and my son Kaleb Wei Jie Kuan, thank you for believing in me and for giving me countless of seemingly endless, fun filled, cherished memories during my research breaks.

To my brothers and sisters in Christ, thanks for your prayer support.

To God be the GLORY … !

Psalms 121:2 'My help comes from the Lord, who made heaven and earth!'

Chapter 1: BACKGROUND TO THE STUDY

This thesis provides an analysis of the adequacy of selected provisions in *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth) (referred to as CLERP 9)[1]. Deficiencies in auditor independence contributed to the collapse of large Australian entities such as HIH and One.Tel in early 2000[2] and as a consequence provided the impetus for auditor independence legal reform in Australia.[3] Likewise, the lack of auditor independence has been attributed to the corporate collapses of United States entities namely Enron and WorldCom.[4] The legislative response in Australia to these matters was the CLERP 9 proposals.[5]

The CLERP 9 proposals for auditor independence law reform contained in the Australian government's discussion paper, titled 'Corporate Disclosure: Strengthening the Financial Reporting Framework' were released to the public in September 2002. These are referred to throughout this thesis as the Relevant Proposals. They were introduced to enhance auditor independence in Australia.

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[1] *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth).
[2] Michael De Martinis, 'Do directors, regulators and auditors speak, hear and see no evil? Evidence from the Enron, HIH and One.Tel collapses' (2002) 15(1) *Australian Journal of Corporate Law* 66, 79.
[3] Larelle Chapple and Boyce Koh, 'Regulatory responses to auditor independence dilemmas – who takes the stronger line?' (2007) 21(1) *Australian Journal of Corporate Law* 1, 1-2, See generally, Ian Ramsay, *Independence of Australian Company Auditors* (Treasury, 2001) 21-22, Anona Armstrong, 'Corporate governance standards: intangibles and their tangible value' (2004) 17 *Australian Journal of Corporate Law* 97-110, Geoffrey George, 'Auditor independence – Who guards the guardians? – A critique of the Ramsay Report into the Independence of Auditors' (2001) 13(3) *Australian Journal of Corporate Law* 328, 332 and The HIH Royal Commission, *Report of the HIH Royal Commission* (Commonwealth of Australia, 2003) Vol 1, [7.2.1].
[4] Paul von Nessen, 'Corporate governance in Australia: Converging with international developments' (2003) 15 *Australian Journal of Corporate Law* 189, 190-191.
[5] Jean Jacques du Plessis, James McConvill and Mirko Bagaric, *Principles of Contemporary Corporate Governance* (Cambridge University Press, 1st ed, 2005) 243 and Emma Ladakis, 'The auditor as gatekeeper for the investing public: Auditor independence and the CLERP reforms – a comparative analysis' (October, 2005) 23(7) *Company & Securities Law Journal* 416, 416.

As part of the Corporate Law Economic Reform Program, proposals which included CLERP 9 formed a component of the themed set of legislative developments in corporate law focused on key economic and public policy principles. These broad objectives of CLERP can be found from the various themes identified as the 'key principles' that should also underpin auditor independence reform.[6] The key principles' emphasis on market integrity, reasonable access to information for all investors, the confidence of individual investors in the fairness and integrity of financial markets, the provision of necessary investor and consumer protection and the consistent and fair application of regulation to encourage high standards of business practice and ethics, were themes that consistently aim to safeguard the public interest. CLERP 9, being the ninth instalment of the CLERP program, was therefore developed with the public interest in mind.

In this thesis it is argued that if the current legislation was designed to serve private interests at the expense of the public interest, there is scope for law reform in relation to audit independence. That is, if CLERP 9 has digressed from the public interest, then CLERP 9 has deviated from achieving its objectives. By using private interest theory to evaluate the development of CLERP 9 in the context of auditor independence, this thesis contends that in some circumstances, the public interest objective has not been achieved.

This chapter provides an overview of the arguments developed in the thesis and is presented in five sections that generally set out the objectives, framework, methods adopted as well as the significance and scope of the study. The last section outlines the chapters for the remainder of the thesis.

1.1 PURPOSE OF THE STUDY

This section provides the purpose of the study. It outlines the major focus of the study and highlights its importance to the credibility and integrity of financial reporting.

[6] Treasury, *CLERP – Policy Framework* <http://www.treasury.gov.au/documents/267/HTML/docshell.asp?URL=index.asp>.

It defines the specific aims and objectives of the study. It also provides the role of the auditor, an introduction to private interest theory and an overview as to why this theory is used to explain the development of the current regime.

Through the use of private interest theory, this thesis critically evaluates the development of the current audit independence regime. The study explains why private interest theory was selected to evaluate how the current law was developed. This thesis evaluates the current regime through the application of private interest theory and draws conclusions as to the appropriateness of the existing regulation from the study.

The thesis proposes that the law relevant to audit independence was developed in some circumstances to serve private interests rather than the stated goal of the public interest, and as a result, the current regime is in need of reform. The thesis will evaluate the extent to which the current legislation was established as a result of lobbying efforts on the part of specific interest groups rather than by consideration of the public interest. This study then proposes practical solutions and alternatives to the existing corporate governance framework to improve the existing requirements for it to be consistent with greater independence (the public interest).[7]

According to the Treasury, six 'key principles' were to be adhered to when developing future instalments of the broader CLERP program to 'ensure that regulation facilitates economic activity and job creation and that contemplated reform will not impede these objectives'.[8] These principles provide a useful tool for analysing and critiquing CLERP 9, being the ninth instalment of the CLERP program. This is because the themes entrenched in these principles can provide a measure of the public interest which assist in determining the rationale for the current regime.

[7] The public interest is the rationale (or one of the main considerations) for new legislation to be introduced as can be inferred from each of the six key CLERP principles as discussed in Chapter 2. Chapter 5 identifies circumstances in which the public interest can be promoted and introduces various proposals that seek to support greater independence on the part of auditors.
[8] Treasury, above n 6.

1.2 FRAMEWORK AND METHODOLOGY

This section introduces the theoretical framework for this study and sets out the methodology used to evaluate the current legislation. The private interest theory of regulation is adopted.

Horwitz has described a theory of regulation as a theory that seeks to explain the development of regulation and how key actors can influence the development of such regulation.[9] Private interest theory proposes that the regulatory outcomes reflect the interests of the most powerful interest groups rather than the stated goal of the public interest. Regulation is, therefore, viewed as a commodity by which powerful interest groups can protect and advance their self-seeking interests.[10]

According to Stigler, private interest theory proposes that self-seeking individuals will organise themselves into politically effective lobby groups in order to protect their respective interests. Applying Stigler's view, the various interest groups that stand to gain/lose the most from the regulatory outcome(s) will seek to influence the regulatory process. This theory also proposes that the regulatory outcome(s) will reflect the self-seeking interests of the most powerful group(s). As a consequence, legislation can be developed to serve private interests rather than the stated objective of the public interest.[11] The major interest groups selected to be analyzed are collectively referred to in this study as the Selected Interest Groups.[12] The Selected Interest Groups have been identified in this thesis as the stakeholders that stand the most to gain (or lose, as the case may be) from any change to the auditor independence requirements. The argument here is that there is auditor independence provided for in the current structure but it is inadequate and should be driven by public, rather than private, interest. This concept is discussed in more detail in Chapter 3. According to Baldwin and Cave, this 'general approach thus

[9] Robert Horwitz, *The Irony of Regulatory Reform – The Deregulation of American Telecommunications* (Oxford University Press, 1st ed, 1989) 34.
[10] Ibid.
[11] George Stigler, 'The Theory of Economic Regulation' (Spring, 1971) 2, No. 1 *The Bell Journal of Economics and Management Science* 3, 21.
[12] See Section 3.5 for the various motivations that can drive the Selected Interest Groups to seek to influence the current audit independence legislation and Section 3.6 for an explanation as to why submissions from various other parties were excluded from detailed analysis.

encompasses theories going under a number of names, notably 'economic', 'Chicago', 'private interest', 'public choice', 'special interest' and 'capture''.[13]

Private interest theory has been used to explain corporate law reform in the United States.[14] Brown and Tarca have applied private interest theory in a separate CLERP 9 proposal that is not directly associated with improving auditor independence and noted that the professional accounting bodies have the ability to wield significant influence in order to promote their respective interests during the accounting standard setting process.[15] The literature suggests[16] that there is some support for reform or modification of the relevant Australian law in relation to auditor independence in general terms. However, a review of the literature indicates that private interest theory has not, as yet, been applied to analyse auditor independence law reform in Australia.

Given that the stated objective of CLERP 9 is the promotion of the public interest, on this basis CLERP 9 auditor independence legal reforms can be measured. Whether these legal reforms are in the public interest is the question which needs to be answered.

As stated previously, this study analyses the significant auditor independence provisions in CLERP 9 (referred to as the Relevant Proposals) and discusses how private interest theory can be applied to explain the development of such regulation. The stakeholders that influence the auditor independence reforms from the perspective of private interest theory (referred to as the Selected Interest Groups) were identified in this study. These stakeholders had made submissions to the Treasury and the Joint Parliamentary Committee on Corporations and Financial Services (referred to as the "**JPCCFS**") at specific points in time during the development of the Relevant Proposals. These submissions provide a basis for evaluating the development of CLERP 9. The

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[13] Robert Baldwin and Martin Cave, *Understanding Regulation – Theory, Strategy and Practice* (Oxford University Press, 1st ed, 1999) 22.

[14] David Haddock and Jonathan Macey, 'Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation' (October, 1987) 30(2) *Journal of Law and Economics* 311, 339 and Randall Kroszner, 'The Motivations Behind Banking Reform' (Summer, 2001) 24(2) *Regulation* 36, 41.

[15] Philip Brown and Ann Tarca, 'Politics, Processes and the Future of Australian Accounting Standards' (October, 2001) 37(3) *ABACUS* 267, 281.

[16] Armstrong, above n 3. This article argues that voluntary standards adopted by various entities can promote good corporate governance, See also George, above n 3. This article argues that the rotation of audit partners does not guarantee auditor independence as there may still exist a conflict of interest due to the auditor and client relationship.

regulatory outcomes as a consequence of the successful lobbying efforts of these stakeholders were noted in this thesis and were compared against the public interest measure. This measure, explained in Chapter 2, was consistent with ideal auditor independence. Chapter 5 provided recommendations for practical future legal reform in circumstances where these regulatory outcomes were found to be inconsistent with ideal auditor independence.

Various interest groups are examined for the purposes of this thesis on the basis that these groups can potentially benefit from or suffer loss as a result of corporate actions from the introduction of new auditor independence legislation. This thesis analyses the lobbying efforts of powerful interest groups being the members of accounting professional bodies[17] (comprising the Accounting Associations, Big 4 Firms, Middle Tier Firms and Small Firms), managers of companies and government officials (comprising of the Accounting Professional & Ethical Standards Board Limited, ASIC, ASX, Auditing & Assurance Standards Board, Companies Auditors & Liquidators Disciplinary Board, Financial Reporting Council) collectively referred to as the Selected Interest Groups.

This analytical study seeks to identify (by reference to the documentation at the time of the legal reform) that in relation to CLERP 9, the successful lobbying of the Selected Interest Groups has resulted in a regime that is not wholly in the public interest. This analysis is undertaken with reference to the collated submissions from the Treasury in relation to the Relevant Proposals, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003* (Cth) referred to as CLERP 9 Bill and the *Corporations Legislation Amendment (Audit Enhancement) Bill 2012* (Cth) referred to as Audit Enhancement Bill public consultation process and the collated submissions from the JPCCFS in relation to the CLERP 9 Bill public consultation process. These submissions obtained from the Treasury and the JPCCFS as a result of the Relevant Proposals, CLERP 9 Bill and Audit Enhancement Bill public consultation process were

[17] See section 4.2 for an explanation as to why the accounting professional bodies have been further subdivided into smaller groups (for the purposes of this thesis) being the Accounting Associations, Big 4 Firms, Middle Tier Firms and Small Firms.

used to ascertain whether any (or all) of the Selected Interest Groups have been successful in obtaining what they have lobbied for.

Private interest theory is used to highlight that in some circumstances, the ideal auditor independence measure has not been met. To the extent that this measure has not been met (where the current regime is found to serve the private interests rather than the public interest), this study provides practical proposals for legal reform to the existing requirements.

1.3 SIGNIFICANCE OF THE STUDY

Auditor independence is an important factor that can enhance the reliability of a corporation's financial statements. Legal reform designed to promote ideal auditor independence, if implemented correctly, can potentially enhance the reliability of a corporation's financial statements. As such, the public interest can be advanced by measures that seek to promote ideal auditor independence. On the other hand, measures that do not seek to promote ideal auditor independence can be considered inconsistent with the public interest. Legal reform that is focused on promoting this ideal auditor independence measure can be considered as advancing the public interest and as such, is consistent with the public interest.[18] Chapter 2 develops this idea further by providing a framework by which the public interest is determined for the purposes of this thesis.

Mautz and Sharaf have suggested that auditor independence is an essential ingredient in the reporting of financial information as it provides much needed credibility to representations made by management in an entity's financial statements.[19] On this view, commentators have regarded the independence of the external auditor as 'the

[18] This is consistent with the accountants' ethical code of conduct to serve the public interest which appears in Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2013) Section 100.1.

[19] Robert Mautz and Hussein Sharaf, *The Philosophy of Auditing*, Monograph No 6 (American Accounting Association, 1st ed, 1961) 204.

cornerstone of the accounting profession'[20] as it is perceived by the public to enhance the reliability and usefulness of an entity's financial statements.[21]

The significance of auditor independence has been described by Lynn E. Turner, the former United States Securities & Exchange Commission Chief Accountant:

> The enduring confidence of the investing public in the integrity of our capital markets is vital. In America today, approximately one out of every two adults has invested their savings in the securities markets … These investments have provided trillions of dollars in capital for companies in the United States and around the globe. That capital is providing the fuel for our economic engine, funding for the growth of new businesses, and providing the necessary investment in new plant and job opportunities for tens of millions of workers … … the willingness of investors to continue to invest … cannot be taken for granted … Public trust begins, and ends, with the integrity of the numbers the public uses to form the basis for making their investment decisions … it is the report of the independent auditor that provides investors with the critical assurance that the numbers in the financial statements have been subjected to an impartial, unbiased, and rigorous examination by a skilled professional. But in order for that report to have credibility with investors, to add value to the process and investors, it must be issued by a person or firm that the investor perceives is free of all conflicts – conflicts that may or will in part, weight on or impair the auditor's judgments about the accuracy of the numbers.[22]

In summary, despite of the many definitions of what auditor independence is and should be, commentators have generally acknowledged that ideal independence means

[20] For example, Robert Mednick, 'Chair's corner' (June 1, 1997) *The CPA Letter* 1, 10 and Brenda Porter, Jon Simon and David Hatherly, *Principles of External Auditing* (2nd ed, 2003) 45.
[21] Abraham Briloff, 'Accountancy and Society: A Covenant Desecrated' (1990) 1 *Critical Perspectives on Accounting* 5, 29.
[22] Lynn Turner, 'Independence: A Covenant for the Ages' (Speech delivered at the International Organization of Securities Commissions, Stockholm, Sweden, June 28, 2001).

that the external auditor must be free from all conflicts of interest (actual and/or perceived) in order to provide an impartial opinion on the client's financial statements.[23]

HIH and One.Tel (as discussed above) are examples[24] of how the lack of auditor independence can erode the credibility of financial reporting. The resultant loss of market confidence in the integrity of the financial statements of these entities has inflicted widespread financial losses amongst the shareholders, financiers and employees of these entities. Commentators have suggested that CLERP 9 was introduced in response to the public outcry following these corporate collapses in order to enhance auditor independence in Australia with the objective of protecting the public interest.[25]

The study advocates that the fine tuning and detailed implementation of some of the proposals in the CLERP 9 Policy Paper[26] were found to be influenced by the lobbying of particular interest groups. As such, there are some provisions in the current regime which can be attributed to (amongst other things) the lobbying efforts of these interest groups. Had it not been for the lobbying efforts of these interest groups, the development of these provisions is likely to have resulted in a different outcome.

How the successful lobbying efforts of the various interest groups compromised ideal auditor independence is explained in Chapter 5. Whether the reduction of auditor independence in these circumstances is in the public interest is discussed. Potential weaknesses in the current regime are highlighted for possible legal reform. Various structures for ensuring auditor independence are considered. It is envisaged that these practical incentives will promote and enhance the public interest in circumstances where the current regime is found to serve private interests rather than the public interest.

Legal reform that is continuously evolving to safeguard the corporate stakeholders in line with ideal standards (where applicable) is consistent with the spirit of CLERP[27] as discussed above 'where a flexible and transparent framework will be more conducive to

[23] Gary Kleinman, Dan Palmon and Asokan Anandarajan, 'Auditor independence: A synthesis of theory and empirical research' (1998) 12 *Research in Accounting Regulation* 3, 4 and John Carey, 'The independence concept revisited' (Spring, 1985) 44 *Ohio CPA Journal* 5, 8.
[24] von Nessen, above n 4.
[25] du Plessis, McConvill and Bagaric, above n 5 and Ladakis, above n 5.
[26] Treasury, *Strengthening the Financial Reporting Framework* (Commonwealth of Australia, 2002) 1-9.
[27] Treasury, above n 6.

innovation and risk taking, which are fundamental elements of a thriving market economy, while providing necessary investor and consumer protection'.[28] This thesis provides practical improvements and alternatives to the current regime in order for it to be consistent with the public interest, so that the public interest can be served better. The issues surrounding auditor independence are not new and the corporate collapses noted in this chapter are examples of how auditor independence may have been compromised prior to the collapse of these corporate entities. The debate can be further informed by the research findings as to whether the current regime serves the interests of the primary users of accounting information. The primary users of accounting information for the purposes of this study comprise of investors and members of the financial community. The focus of any legal reform will be concerned with the economic needs of the primary users of accounting information, namely individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors. The proposals for legal reform (in Chapter 5) would enhance auditor independence and further strengthen the confidence of the primary users of accounting information (the investing public and the financial community) in the current regime. The primary users of accounting information stand to benefit from the proposals for legal reform (in Chapter 5) as any increase in shareholder value as a result of these proposals have the potential to increase the financial wealth of the primary users of accounting information.

1.4 SCOPE OF THE STUDY

This study focuses on whether effectively organized groups have lobbied successfully for their respective interests and whether the government has been influenced by such lobbying efforts at the expense of the public interest. Effectively organized groups have an advantage over the unorganized individual as these groups have access to valuable resources such as information, time and money which can be utilized to protect their own more significant financial interests. This study analyzes whether the auditor independence requirements in the current regime have developed in a

[28] Ibid.

manner consistent with serving private interests. Where the current regime is consistent with serving private interests rather than the public interest, this study provides practical proposals for law reform.

The Selected Interest Groups were identified because these groups will value the outcome of any company law reform in relation to auditor independence. As discussed in detail in Chapter 3, the members of accounting professional bodies have their livelihoods at stake, managers of companies (producer group) have to constantly ensure that audit expenses are kept under control and government officials have the incentive to maintain their respective position of power or privilege within the community.

This study discusses how the Selected Interest Groups may have had an impact in controlling and overseeing the regulation of financial reporting through the lobbying efforts of these groups. The public interest, as can be inferred from the key principles of CLERP, may not have been the overriding consideration for the current regime but rather secondary to the respective interests of the Selected Interest Groups. This study essentially argues that the current regime is the outcome of intense competition among various interest groups. No single group however, can claim that it has been successful in achieving all of its lobbied objectives. This is because the lobbying efforts of these groups have not achieved complete success in the implementation of their respective proposals. In some of these circumstances, the government has enacted into law a moderated final outcome in order for the appearance of social gain to be distributed. This is discussed in more detail in Chapter 4.

It is important to note however, that three limitations have been identified in this research methodology. The first relates to the data analysed. The data analysed consists of information obtained from Treasury and JPCCFS submissions during specific points in time of the Relevant Proposals, CLERP 9 Bill and the Audit Enhancement Bill public consultation process. This information was used to ascertain whether any (or all) of the Selected Interest Groups have been successful in obtaining what they have lobbied for. Various other sources of information may exist which have not been collated for the purpose of analysis. As such, the Treasury and JPCCFS submissions do not comprise of (and neither do they represent) all of the views from all interest groups at any point in

time. These submissions however represent the official responses received by the government from the various interest groups as a result of the public consultation process. The candidate is confident that the submissions collated (comprising of more than 180 submissions), provide a reliable and adequate source of information that can be analysed from the perspective of private interest theory.

The second limitation relates to the submissions examined. The scope of this thesis and the application of private interest theory in this thesis do not consider every submission made in response to the Relevant Proposals. This is because the traditional literature on private interest theory[29] in the context of corporate and accounting legislation have broadly focused on the lobbying efforts of groups such as the Selected Interest Groups. As a consequence, some submissions have been ignored. A review of these excluded submissions (as explained in Section 3.6 of this thesis) have found that these other parties have had their proposals ignored by the government when the Selected Interest Groups had lobbied for different outcomes. These findings were consistent with private interest theory as they indicated that these other parties did not have any influence on the regulatory outcome as opposed to the Selected Interest Groups.

The third limitation relates to the existence of other theories and perspectives. It is acknowledged that other theories and perspectives exist, apart from private interest theory. The application of other theories and perspectives to this study in place of private of interest theory, may lead to a different conclusion. The Selected Interest Groups were identified because these groups will value the outcome of any company law reform in relation to auditor independence. As discussed in detail in Chapter 3, private interest theory is well placed to contribute to this knowledge base as it can be used to critically analyse the development of the current regime in view of the respective preferences of the Selected Interest Groups. This theory can provide an explanation as to how and why the current regime has developed the way it has. Through the use of this theory, potential

[29] Stigler, above n 11, 12, Sam Peltzman, 'The Economic Theory of Regulation after a Decade of Deregulation' (1989) Special Issue *Brookings Papers on Economic Activity* 1, 7, Richard Posner, 'Theories of Economic Regulation' (Autumn, 1974) 5, No. 2 *The Bell Journal of Economics and Management Science* 335, 343 and Gary Becker, 'A Theory of Competition Among Pressure Groups for Political Influence' (August, 1983) 98, No. 3 *The Quarterly Journal of Economics* 371, 373-374.

shortcomings in the legislation (where the ideal auditor independence measure has not been met) can be identified and highlighted for future legal reform.

Finally, it is important to note that this study is focused on auditor independence and not on the practice of audit on a broader or wider perspective. As such, the proposals recommended in Chapter 5 are envisaged to specifically improve auditor independence.

1.5 THESIS OUTLINE

This thesis is structured as follows:

Chapter 2 provides a historical insight into the development of CLERP 9. This analysis into the background of CLERP 9 provides supporting evidence for the rationale of CLERP 9 and for the 'public interest'. This chapter also explains and expands on how ideal auditor independence has been defined by the literature. It describes what ideal auditor independence is (the public interest) by considering the significance of auditor independence and the concept of independence. It also reviews the significant auditor independence requirements in the current regime.

Chapter 3 provides the theoretical framework adopted in this thesis to analyse the effectiveness of the CLERP 9 reforms. The chapter provides an overview of private interest theory, including discussion of the stakeholders involved in private interest theory and the concept of ideal auditor independence from the perspective of those stakeholders. Chapter 3 provides support for the use of private interest theory to evaluate how the current audit independence regime emerged. Chapter 3 concludes that this theory is well placed to explain the reasons for the various interest groups to control and oversee the regulation of financial reporting. The Selected Interest Groups which stand to benefit the most from controlling and overseeing the development of the current regime were analysed.

Chapter 4 discusses how the Selected Interest Groups have had an impact in controlling and overseeing the regulation of financial reporting. The preferences of the various stakeholders as far as independence is concerned and the extent to which these preferences are evident in legal reform are examined. Submissions obtained from the

Treasury and the JPCCFS as a result of the Relevant Proposals, CLERP 9 Bill and Audit Enhancement Bill public consultation process are used to ascertain this.

Chapter 5 analyses whether the existing auditor independence requirements in the CLERP 9 regime are consistent with private interest theory. It provides recommendations for practical legal reform where the current regime is found to serve private interests rather than the public interest.

The concluding chapter explains how the research findings can be applied to new proposals for legal reform. It advocates the use of private interest theory as an alternative method by which legal proposals in relation to auditor independence can be evaluated.

1.6 SUMMARY

An understanding of what auditor independence means is important for the purposes of this thesis. In addition, an understanding of the various facets of independence is important in this thesis as the development of any proposed legal reform should take these into consideration.

The study explores (as far as auditor independence is concerned) whether the development of the current regime has been motivated by the self-seeking interests of the Selected Interest Groups rather than the public interest. The findings from this study support the proposal of this thesis that there is a case for reform of the existing requirements in the current regime in respect of independence. This is because in some instances, these have been structured to serve private interests rather than the public interest. These have benefited the various interest groups at the expense of greater auditor independence (the public interest). When analysed from the perspective of private interest theory, there is scope for further law reform to the current regime in relation to auditor independence.

The next chapter provides a review of the historical background to CLERP 9 in order to establish that a key motivation for CLERP 9 was the public interest. Chapter 2 explains what the public interest means in the context of ideal auditor independence and provides a definition of the public interest which will be used in this thesis to determine

whether the development of the current regime has been motivated by the self-seeking interests of the Selected Interest Groups rather than the public interest.

Chapter 2: AUDITOR INDEPENDENCE AND THE PUBLIC INTEREST

2.1 INTRODUCTION

Various commentators have proposed legal reform to auditor independence both before and after the implementation of CLERP 9.[30] Whilst the CLERP 9 reforms were designed to improve auditor independence, what appears to be lacking in these CLERP 9 reforms is a measure by which the effectiveness of these legal reforms can be assessed. The extent of auditor independence reforms required will vary, depending on whose interests are to be protected. Section 2.2 of this chapter proposes that the key CLERP principles provide guidance as to whose interests are to be protected.

In order to determine the extent to which auditor independence legal reforms in CLERP 9 are adequate, a benchmark needs to be established by which these legal reforms can be compared against. Legal reforms that are not consistent with this measure can then be identified. These inconsistencies can then be addressed by the development of new proposals for legal reform that can be designed to meet this objective.

This thesis proposes that the key CLERP principles provided guidance as to whose interests are to be protected. The key CLERP principles contained various themes that consistently aim to safeguard the public interest. Legal reform should be specifically designed to support this purpose. This chapter looks into the historical background of CLERP and establishes that an overriding objective of CLERP was the public interest.

Various commentators[31] have stated that the public interest has often been used as a significant reason for the introduction of new legal reforms. These commentators have

[30] Chapple and Koh, above n 3, Ramsay, above n 3, Armstrong, above n 3, George, above n 3 and The HIH Royal Commission, above n 3.
[31] Clarke Cochran, 'Political science and "the public interest"' (1974) 36(2) *The Journal of Politics* 327, 327 and Steven Dellaportas & Laura Davenport, 'Reflections on the public interest in accounting' (2008) 19 *Critical Perspectives on Accounting* 1080, 1080.

also suggested that despite the public interest being a significant motivation for new legislation, there appears to be no consensus as to what this term really means.[32]

This chapter provides a definition of the public interest for the purposes of this thesis. It is argued in this chapter that the public interest can be defined by reference to the key CLERP principles and the code of ethics for accountants. The auditor independence legal reforms in CLERP 9 can be measured against this definition of the public interest in order to assess the adequacy of the current regime. The normative perspective of the public interest is adopted in this thesis as a framework for analysis.[33] This perspective subscribes to ideal normative principles designed to enhance the common good of the community.[34] The term 'community' however, can potentially include all stakeholders.

Cohen has described a stakeholder as being an entity or a person who holds an interest in something and as a consequence will be susceptible to any change circumstance that can potentially affect that which the entity or person is concerned with.[35] Freeman and Reed have referred to corporate stakeholders as entities or persons that have an interest in a corporate entity and as a result are affected by corporate actions that impact the corporate entity's future.[36] On this view, the definition of corporate stakeholders is broad and can include the entity's employees, financiers, advisors and shareholders.[37]

This chapter explains how this term 'community' can be applied to a clearly identified group of people. Proposals for legal reform can then be tailored to specifically benefit this clearly identified group of people, rather than an ambiguous group of people at large. Legal reform that seeks to enhance the common good of this clearly identified group of people can therefore be considered for the purposes of this thesis, to be in the public interest.

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[32] Cochran, above n 31 and Dellaportas & Davenport, above n 31.
[33] Cochran, above n 31, 330.
[34] Ibid.
[35] Stephen Cohen, 'Stakeholders and Consent' (Spring, 1995) 14(1) *Business and Professional Ethics Journal* 1, 1-3.
[36] Edward Freeman and David Reed, 'Stockholders and Stakeholders: A New Perspective on Corporate Governance' (Spring, 1983) 25(3) *California Management Review* 88, 91.
[37] Ibid.

Measures aimed at supporting ideal auditor independence can be consistent with the public interest. This chapter explains what ideal auditor independence is and discusses how legal reform designed to enhance ideal auditor independence can promote the public interest. It acknowledges however that total ideal auditor independence cannot be achievable under current institutional arrangements.

As increased auditor independence regulation can often increase compliance costs, one can assume that groups who are profit driven would be more likely to object to incurring additional costs if they have to bear those costs. The success or failure of the continued profitability of many accounting firms (where the majority of the fee earners comprise members of the Accounting Associations) and listed entities (these entities are also included in the category of Managers of Companies (Producer Group)) depend on the amount of profit these entities can generate in any given financial year.

For example, the effect of increasing the frequency of compulsory audit partner rotation on audit firms may result in increased fee earner time spent auditing the same entity. Familiarity with the entity's business and audit practices can lead to significant reduction in cost for the audited entity. If the audited entity is not willing to bear this additional cost, the audit firm will have to bear this additional cost. The profitability of the audit firm will be reduced. On the other hand if the audited entity is willing to take on this additional cost, the profitability of the audited entity will be reduced. This increased cost could also be shared between the audit firm and the audited entity. Regardless of the scenario, the end result can be summarised as decreased profit for the audit firm or the audited entity or both.

Not everyone, however, will be particularly concerned about such potentially adverse financial consequences of increased auditor independence regulation. This category of people would most likely be those who are least affected financially by the outcome of such regulation. The average person who neither works for the audit firm or the audited entity, (that has no direct financial interest in either the audit firm or the audited entity), will be less likely to object to the introduction of new legislation that will increase the compliance cost of either the audit firm or the audited entity or both. Other examples of people who may not object can include those whose financial portfolios are

not heavily dependent on the potentially adverse performance of listed shares as a result of increased regulation or perhaps even those who perceive that the benefits of increased auditor independence regulation outweigh the costs.

In order to analyse whether these reforms are consistent with the concept of ideal auditor independence, it is necessary to determine the rationale for CLERP 9. This involves obtaining an understanding of the historical background and context of the broader CLERP program from which CLERP 9 was enacted. The next section is dedicated to this.

2.2 OBJECTIVE OF CLERP 9

The CLERP program was announced in March 1997 and involved a fundamental review of key areas of regulation which affected business and investment activity in order to facilitate strong economic growth.[38] The objective of CLERP can be identified from the various themes in the 'key principles' discussed in an important discussion paper, titled 'CLERP – Policy Framework'.[39] These themes consistently aim to safeguard the public interest. CLERP 9, being the ninth instalment of the CLERP program was to be developed within this broader framework and with the public interest in mind.

These principles provided a useful tool for developing or critiquing corporate law and governance reforms. This is because the spirit of these principles or the themes entrenched in these principles can assist in determining the rationale for the current regime.

The explanation of the six 'key principles', contained in the 'CLERP – Policy Framework' document under the heading 'Economic Approach to Business Regulation' is reproduced in Appendix 1.[40]

It would appear that the public interest rationale is the overriding motivation (or at the very least, one of the main considerations) for the current regime as can be inferred from the selected excerpts (with emphasis in bold) from each of the six key CLERP principles as set out below:

[38] Treasury, above n 6.
[39] Ibid.
[40] Ibid.

3.1 Market Freedom

'…Business regulation can and should help markets work by enhancing ***market integrity*** and capital market efficiency. …'

3.2 Investor Protection

'…business regulation should ensure that ***all investors have reasonable access to information*** regarding the risks of particular investment opportunities. …'

3.3 Information Transparency

'... Disclosure requirements increase the ***confidence of individual investors in the fairness and integrity of financial markets*** and, by fostering confidence, encourage investment. …'

3.4 Cost Effectiveness

'… A flexible and transparent framework will be more conducive to innovation and risk taking, which are fundamental elements of a thriving market economy, ***while providing necessary investor and consumer protection***.'

3.5 Regulatory Neutrality and Flexibility

'Regulation should be ***applied consistently and fairly*** across the marketplace. …'

3.6 Business Ethics and Compliance

'… Fostering an environment which encourages ***high standards of business practice and ethics*** will remain a central objective of regulation, as will effective enforcement.'

Various public interest themes can be gleaned from these excerpts. The emphasis on market integrity, reasonable access to information for all investors, the confidence of individual investors in the fairness and integrity of financial markets, the provision of necessary investor and consumer protection and the consistent and fair application of

regulation to encourage high standards of business practice and ethics, are all themes that consistently aim to safeguard the public interest.[41]

These themes seek to protect the financial interests of the general community. The confidence of individual investors in the capital markets is strengthened when there is integrity in the financial markets. A business environment that promotes values such as fairness and integrity reduces the risk of investors suffering financial loss as a result of dishonest conduct by certain individuals. The provision of reasonable access and timely information to all investors strengthens the confidence of individual investors in the capital markets. Investors need to have access to such information in order to make informed decisions in relation to their respective investments.[42]

The consistent and fair application of legislative provisions that support values such as fairness and integrity can have the effect of deterring dishonest individuals from pursuing ill-gotten gains through deceitful means. A fair and honest business environment is conducive for encouraging further investment as investors would be more willing to invest in financial markets that are considered by them to be safe from fraudulent schemes. Likewise legislative mechanisms that support the provision of timely and accessible information to all investors have the potential to attract more investment as investors have the ability to make timely and informed decisions concerning their investments.[43]

In view of the themes above in support of the public interest rationale as the overriding motivation (or at the very least, one of the main considerations) for the current regime, it is now worthwhile considering what the public interest means.

It is argued that if CLERP 9 has digressed from the public interest, then CLERP 9 has deviated from achieving its objectives. Therefore, it is important to define what is meant by the public interest. This way, a measure (being the public interest) can be established to evaluate CLERP 9. The next section identifies what the public interest means in this context and sets out the parameters for the measure to be applied in this study.

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[41] Ibid.
[42] Ibid.
[43] Ibid.

2.3 WHAT IS THE PUBLIC INTEREST?

This chapter has demonstrated that CLERP was to be developed with the "public interest" in mind. Auditor independence reforms therefore have to be designed in such a manner so as to protect the interests of the public. What the public interest means for the purposes of this thesis needs to be determined as this is the benchmark by which auditor independence reforms are to be compared against. This section provides an overview of the various interpretations of what the public interest might be and provides support for the adoption of the normative perspective of the public interest for the purposes of this thesis. This section adopts the argument developed by Dellaportas & Davenport to provide a definition of the public interest based on the normative perspective of the public interest. When the existing auditor independence reforms are assessed against this definition of the public interest, proposals for legal reform can be developed in circumstances where the current regime is found to be inadequate. These proposals can be designed with the view of protecting the interests of the public, with this definition of the public interest in mind, consistent with the spirit of CLERP as set out in the key CLERP principles.

2.3.1 Public Interest Theories

Cochran has identified four categories of what the public interest means. Cochran draws on the prominent works of political scientists such as Cassinelli, Bentley, Smith and Flathman and segregates the public interest theories advocated by these commentators into four broad categories.[44] These four categories comprise of the normative, abolitionist, process and consensualist theories.[45]

Cochran's normative theory of the public interest utilises Cassinelli's view that the public interest is 'the highest ethical standard applicable to political affairs.'[46] According to Cochran, the public interest involves 'an ethical standard for evaluating specific public policies and a goal which the political order should pursue.'[47] The public interest in Cassinelli's view is an ethical concept and the process of group accommodation and

[44] See generally, Cochran, above n 31, 327-355.
[45] Ibid.
[46] Carlos Cassinelli, 'Comments on Frank J. Sorauf's "The Public Interest Reconsidered"' (August, 1958) 20(3) *The Journal of Politics* 553, 553.
[47] Cochran, above n 31, 330.

compromise being the process of democracy is a suitable method to achieve this as it promotes liberty and equality for all.[48] On this view, 'the public interest (or common good) is a normative concept and the relevant norm is the general good of a whole community.'[49] The aim is the common good of the community as this 'enhances their common life and is shared by all.'[50] The measure by which to determine whether a proposed public policy is in the public interest will solely depend on 'whether it will contribute more to the common good than will alternative policies.'[51]

Bentley's theory of the public interest is categorised by Cochran as abolitionist theory.[52] The public interest as explained by Bentley, is the result of pressure, the 'push and resistance' between various groups promoting their respective self-interests.[53] According to Bentley, there is no such thing as group interest. The only outcome is known as 'group phenomena' and that 'society itself is nothing other than the complex of the groups that compose it.'[54] In addition, there is no notion of the common good as there is no suitable method capable of measuring feelings and/or ideas.[55]

Cochran's process theory adopts Smith's perspective of the public interest.[56] According to Smith, the public interest is the result of the 'consensus-responsive decision-making process'.[57] As such, the process by which competing policies are decided where 'consensus may be used to the fullest possible extent in resolving conflict harmoniously' is the public interest.[58] The process referred to by Cochran comprises of the mechanisms in place, characteristic of a democratic system which allow for accommodation and compromise.[59]

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[48] Cassinelli, above n 46, 555-556.
[49] Cochran, above n 31, 330.
[50] Ibid.
[51] Ibid.
[52] Cochran, above n 31, 332.
[53] Arthur Bentley, *The Process of Government* (The Belknap Press of Harvard University Press, 1st ed, 1967) 258-259.
[54] Ibid 222.
[55] Ibid 172.
[56] Cochran, above n 31, 339.
[57] Howard Smith, *Democracy and the Public Interest* (University of Georgia Press, 1st ed, 1960) 111.
[58] Ibid 159.
[59] Cochran, above n 31, 341.

The consensualist theory as explained by Cochran adopts Flathman's concept of the public interest.[60] According to Flathman the public interest is not only a result of the process of accommodation and compromise, but that the effects of such a policy needs to be tested against community values and moral principles.[61] Flathman defines community values as interests that are valued by the majority of the community.[62] This theory expands on the concept of process theory to include as Cochran puts it 'to employ community values as well as individual interests, and to give reasons in terms of these values for their decisions.'[63] Flathman is of the view that the purpose of moral principles is to guide conduct and the moral reasoning that follows is used to validate the legislative proposal.[64] This view of the public interest has its roots in Cochran's normative concept of the public interest as discussed above. This is because it subscribes to the ideal normative concept of enhancing the common good of the community. Legal reform as a consequence must be aligned with community values and moral principles for the common good.

2.3.2 Why this thesis adopts the normative perspective of the public interest

This thesis utilises the normative concept of the public interest developed by Cochran. It does not adopt the other three categories of the public interest also developed by Cochran, namely, the abolitionist theory, process theory and the consensualist theory. The normative theory is applied in this thesis, as this theory subscribes to ideal normative principles and values that are consistent with the objective of CLERP. The key CLERP principles[65] provide support for the utilisation of this normative theory for the purposes of defining the public interest.

The objective of CLERP is the enhancement, protection and preservation of the common good shared by the financial community. This is a normative concept. This is because the aim of CLERP is to protect the financial interests of individual investors.

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[60] Ibid 348.
[61] Richard Flathman, *The Public Interest An Essay Concerning the Normative Discourse of Politics* (John Wiley & Sons, Inc., 1st ed, 1966) 82.
[62] Ibid 69.
[63] Cochran, above n 31, 351.
[64] Flathman, above n 61, 184 and 186.
[65] Treasury, above n 6. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.

This can be achieved by the development of legislative provisions that seek to support fairness and integrity in the financial markets as well as the provision of reasonable access and timely information to all investors. In seeking to protect the financial interests of individual investors, CLERP enhances the common good and the life shared by the community. This objective can be derived from the key CLERP principles' emphasis on market integrity, reasonable access to information for all investors, the confidence of individual investors in the fairness and integrity of financial markets, the provision of necessary investor and consumer protection and the consistent and fair application of regulation to encourage high standards of business practice and ethics.[66]

The requirement that a policy adhere to prescribed objectives that enhance the financial well-being of the community as identified in the key CLERP principles[67] is consistent with the normative concept of the public interest. As a result, policies that seek to contribute more to the common good of the financial community being the public interest will be given preference over alternative policies.

Interest group politics play a significant part of the public interest in the abolitionist theory.[68] This theory relies heavily on the assumption that competing interest groups seek to promote their own respective interests. The common good is not a consideration in the abolitionist theory. The public interest is the outcome of such competing interests.[69] This theory assumes that the outcome of such interest group politics, is in the public interest. Powerful interest groups will seek to lobby for control of the outcome so as to protect their respective interests. These compact and highly organised interest groups have the ability to use their resources such as time and money to successfully lobby for legal reforms at the expense of the unorganised individual. This is not consistent with the spirit of CLERP. There is in the abolitionist theory no common objective that seeks to enhance, protect and preserve the common good shared by the financial community. Rather, the opposite can occur. On this view, the well-being of the financial community can be jeopardised in circumstances where these interest groups are

[66] Ibid. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.
[67] Ibid. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.
[68] Cochran, above n 31, 332.
[69] Ibid.

successful in lobbying for a legislative outcome that enhances their respective interests at the expense of the rest of the financial community.

The process of accommodation, compromise and majority consensus, the hallmarks of a fully functional democratic system is attributed to process theory.[70] This theory refers to the procedural mechanisms in place that facilitate this process.[71] The consequence of legal reform as a result of this process, need not necessarily be in the common good. Rather, the public interest is attained when this process has taken its full course.[72] This theory assumes that as long as the democratic process has taken its full course, the outcome whatever it may be is in the public interest. This is because in a fully functioning democratic system, policies that have majority voter support will prevail. This democratic process however, does not guarantee that the result of such a process will produce a legislative outcome that adheres to the normative principles and values entrenched in the key CLERP principles.[73] As in the abolitionist theory described above, process theory also fails to take into account the existence of powerful interest groups that seek to influence the outcome of such a process in order to serve their own respective interests rather than for the common good of the financial community as subscribed to by CLERP.

The consensualist theory emphasises that the process of accommodation, compromise and majority consensus, must adhere to community values and moral principles.[74] In addition to the democratic legislative process of creating new law, this theory focuses on the consequences of such policy proposals.[75] According to this theory, the reasons as to how community values and moral principles are reflected in these proposals have to be provided.[76] The consensualist theory endorses the normative concept as it requires that community values and moral principles be aligned to the interests of the majority consensus.[77] These normative community values and moral

[70] Ibid 339.
[71] Ibid.
[72] Ibid.
[73] Treasury, above n 6. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.
[74] Ibid 348.
[75] Ibid.
[76] Ibid.
[77] Ibid.

principles essentially comprise of ideals and principles envisaged to enhance the common good of the community. This theory is again flawed for the same reasons given for the abolitionist theory and process theory as described above. As long as the process (of accommodation, compromise and the need for a majority vote prior to the introduction of a legislative proposal into law) is observed and reasons are provided (as to how normative community values and moral principles are reflected in these proposals) to justify these proposals, the legislative outcome can still be influenced by powerful interest groups that stand to benefit more by the introduction of these proposals when compared to the unorganised individual. This result can potentially provide preferential treatment to these powerful groups and is not consistent with the objective of CLERP that seeks to enhance, protect and preserve the common good shared by the financial community. In contrast, the normative theory of the public interest would automatically reject proposals that can provide preferential treatment to these powerful groups on the basis that these are not in the best interests of all the financial community.

2.3.3 The accountant's perspective of the public interest

The four concepts of the public interest developed by Cochran as discussed above, are abstract theories that provide a broad framework for the various interpretations of the term the public interest. The application of the normative perspective of the public interest in this thesis relies on the specific framework developed by Dellaportas & Davenport which incorporates the accountant's perspective of the public interest.

Dellaportas & Davenport have applied Cochran's normative concept of the public interest to give meaning to the term the 'public interest'.[78] According to them, this normative perspective is consistent with the accountants' ethos which can be observed in the code of ethics.[79] They are of the view that 'accounting associations use codes of

[78] See generally, Dellaportas & Davenport, above n 31, 1080-1096.
[79] The definition of the public interest can be found in the now superseded Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2006) Section 100.1.1 and the members' obligation to serve the public interest can be found in Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2013) Section 100.1.

ethics to create expectations of professional behaviour that are ostensibly aimed at benefiting third parties'.[80]

In their opinion, accountants are required to comply with 'fundamental principles of professional conduct such as expertise, knowledge, competence and integrity'.[81] In doing so, they are obligated to 'protect the economic interests of third parties by facilitating an efficient and effective economic decision making process through the provision of relevant and reliable economic data'.[82] This means that members of the profession are obligated to protect the economic interests of the collective well-being of the public.[83]

2.3.4 The public interest defined

This section adopts the method developed by Dellaportas & Davenport, to answer two questions (1) who exactly is the public and (2) what are the interests of the public.[84] This way, the public interest can be defined for the purposes of this thesis in order to establish a measure to assess the adequacy of the current regime. Where the public interest is found to be compromised, legal reform that will enhance the public interest is proposed in Chapter 5.

This approach is adopted as the normative ideals upheld in the normative theory can similarly be applied here. The normative principles as set out in the key CLERP principles[85] can be utilised to give meaning to the term the public interest.

2.3.5 Who exactly is the public?

Dellaportas & Davenport have stated that the term 'public' is defined in the accountants' code of ethics as 'the collective well-being of the community of people and

[80] Laura Davenport & Steven Dellaportas, 'Interpreting the Public Interest: A Survey of Professional Accountants' (2009) 48(19) *Australian Accounting Review* 11, 12.
[81] Dellaportas & Davenport, above n 31, 1093.
[82] Ibid.
[83] Ibid 1093-1094.
[84] Ibid 1088-1089.
[85] Treasury, above n 6. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.

institutions that the members serve.'[86] They are of the view that this definition of the public which can potentially include all stakeholders is not practical in application.[87] This is because accountants prepare financial information for particular user groups and not the public at large.[88] As such, the expansion of this definition to include non-users of accounting information may not be tenable.[89] A practical solution to this can be found in the key CLERP principles.[90] The key CLERP principles can be seen to limit the term 'public' to a certain category of people and not the whole community. Utilising the same reasoning behind Dellaportas & Davenport's method, the 'practical limitations of serving the wider community of stakeholders that is associated with the normative definition of the public' appears to have been addressed by the key CLERP principles which limits the scope of the public to primary users of accounting information.[91] The emphasis on market integrity, reasonable access to information for all investors, the confidence of individual investors in the fairness and integrity of financial markets, the provision of necessary investor and consumer protection and the consistent and fair application of regulation to encourage high standards of business practice and ethics, from the key CLERP principles are themes that consistently aim to safeguard the primary users of accounting information.[92]

According to Dellaportas & Davenport, in identifying the primary users of accounting information, emphasis is given to specific user groups and their information needs.[93] As such, the primary users of accounting information will typically comprise of investors and members of the financial community.[94] The code of ethics specifically

[86] The definition of the public interest can be found in the now superseded Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2006) Section 100.1.1.
[87] Dellaportas & Davenport, above n 31, 1088.
[88] Ibid.
[89] Ibid.
[90] Treasury, above n 6. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.
[91] Ibid.
[92] Ibid. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.
[93] Dellaportas & Davenport, above n 31, 1090.
[94] These primary users of accounting information are referred to in Paragraph 9 of the Australian Accounting Standards Board, *The Framework for the Preparation and Presentation of Financial Statements 2009* <http://www.aasb.gov.au/admin/file/content105/c9/Framework_07-04_COMPdec07_01-09.pdf >.

includes these user groups as part of the wider definition of the 'public'.[95] These user groups are described as 'investors, the business and financial community, and others who rely on the objectivity and integrity of members to maintain the orderly functioning of commerce'.[96]

The key CLERP principles provide further clarity as to the identity of the primary users of accounting information. The themes in the key CLERP principles seek to protect the individual investor. The confidence of individual investors in the capital markets is strengthened when market fairness and integrity are both encouraged.[97] The provision of reasonable access and timely information also increases investor confidence as investors need to have access to such information in order to make informed decisions. [98]

Investor protection is a recurring theme throughout the key CLERP principles. What this means is that the definition of the term public can for the purposes of this thesis be narrowed to individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors.

2.3.6 What are the interests of the public?

Dellaportas & Davenport have stated that 'interests are asserted if the benefit in question can plausibly be connected to the individuals to whom the definition relates.'[99] Where it concerns accounting, they are of the view that this is likely to occur when financial reporting serves the economic interests of direct user groups.[100] As the code of ethics is silent on the term 'interest', they are of the opinion that the key to understanding the term 'interest' lies in the phrase 'the collective well-being'.[101] In order to better

[95] The definition of the public interest can be found in the now superseded Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2006) Section 100.1.1.
[96] The definition of the public interest can be found in the now superseded Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2006) Section 100.1.1.
[97] Treasury, above n 6. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.
[98] Ibid.
[99] Dellaportas & Davenport, above n 31, 1089.
[100] Ibid.
[101] Ibid.

understand this phrase, this thesis refers to the key CLERP principles[102] to explain the meaning of the 'collective well-being'.

The key CLERP principles that aim to safeguard the primary users of accounting information as discussed above, (the emphasis on market integrity, reasonable access to information for all investors, the confidence of individual investors in the fairness and integrity of financial markets, the provision of necessary investor and consumer protection and the consistent and fair application of regulation to encourage high standards of business practice and ethics)[103] are also consistent with safeguarding the economic interests of the primary users of accounting information. The Second Reading Speech of the CLERP 9 Bill states as follows:

> The draft Bill continues the work of the Government's Corporate Law Economic Reform Program, to modernise business regulation and foster a strong and vibrant economy, progressing the principles of market freedom, investor protection and quality disclosure of relevant information to the market.[104]

This read in conjunction with the key CLERP principles emphasise that CLERP 9 is concerned with promoting a solid, stable and dynamic economy. As such, CLERP 9 legal reform was aimed at the primary users' broader economic interests. The interests in question are concerned with the economic needs of the primary users of accounting information.

Mechanisms that promote ideal auditor independence can promote the public interest. In order to gain a better appreciation of what ideal auditor independence is, the next section discusses the significance of independence, introduces commentary on auditor independence and explains the various facets of independence. It also acknowledges that ideal auditor independence is only an ideal and that whilst it may be in the public interest for the current regime to be designed to support this objective, this ideal cannot be completely achieved within current institutional arrangements.

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[102] Treasury, above n 6. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.
[103] Ibid. See discussion in Section 2.2 for a more in-depth analysis of the key CLERP principles.
[104] Peter Costello, 'Second Reading Speech of the CLERP 9 Bill' (Speech delivered at the House of Representatives, Canberra, 3 December 2003).

2.4 AUDITOR INDEPENDENCE: ITS SIGNIFICANCE, COMMENTARY, ITS VARIOUS FACETS AND THE IDEAL

An overview of the significance of auditor independence is provided to highlight the importance of auditor independence in the development of corporate legal reform. Auditor independence has been a recurring issue[105] and will continue to be a contentious issue. Its significance to the development of corporate legal reform makes it important for policy makers to fully consider what is at stake and to understand that the implementation of auditor independence legal reform can potentially have far reaching consequences for the good or to the detriment of the public interest.

2.4.1 The significance of auditor independence

The significance of auditor independence has been a much written about topic long before the corporate collapses such as HIH and One.Tel which provided the impetus for significant auditor independence legal reforms to the current regime.[106] Auditor independence has been described as the cornerstone of auditing.[107] This is because without the independence of the external auditor, the financial reports of an entity cannot be relied upon to give a true and fair view of the entity's financial position and therefore would be perceived by the investing public to have no value.[108]

In discussing CLERP 9, Justice Owen highlighted the importance of auditor independence in the HIH Final Report, as follows:

> Auditor independence is a critical element going to the credibility and reliability of an auditor's reports. Audited financial statements play a key role promoting the efficiency of capital markets and the independent auditor constitutes the principal external check on the integrity of financial statements.
>
> … In the absence of a competently and independently performed audit, there is increased risk to the efficiency of capital markets. There is a danger that the audit report will lure users into a false sense of security that there has been an independent scrutiny of the financial report when there has not.[109]

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[105] See generally, Ramsay, above n 3.
[106] Ibid.
[107] Mednick, above n 20 and Porter, Simon and Hatherly, above n 20.
[108] Briloff, above n 21.
[109] The HIH Royal Commission, above n 3.

The Ramsay Report noted that auditor independence plays a significant part in contributing to the efficiency of the capital markets as follows:

> (a) adding value to financial statements
>
> (b) adding value to the capital markets by enhancing the credibility of financial statements
>
> (c) enhancing the effectiveness of the capital markets in allocating valuable resources by improving the decisions of users of financial statements
>
> (d) assisting to lower the cost of capital to those using audited financial statements by reducing information risk.[110]

In addition, the HIH Final Report stated that auditor independence further promotes the efficiency of the capital markets by 'enhancing the consistency and comparability of reported financial information in Australia.'[111]

The US Supreme Court highlighted the special function that auditors owe to the investing public when it stated:

> The independent public accountant performing this special function owes allegiance to the corporation's creditors and stockholders, as well as the investing public. This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[112]

It is important to consider the significance of auditor independence as set out above in order to gain an appreciation of its potential impact on corporate legal reform. By considering the significance of auditor independence, a better understanding of the way in which corporate legal reform has evolved in relation to auditor independence can be obtained.

To establish a measure by which auditor independence can be assessed, it is useful to look at what judges and academics have commented on this topic. It is a worthwhile

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[110] Ramsay, above n 3, 21.
[111] The HIH Royal Commission, above n 3.
[112] *United States v Arthur Young & Co*, 79 L Ed 2d 826-838 (US Supreme Court, 1984). Although not binding, Ottaway has referred to this quote by the US Supreme Court to highlight the importance of auditor independence in Australia when examining the utility of audit firm rotation as a means to improve auditor independence. Ottaway, Joanne, 'Improving Auditor Independence in Australia: Is 'Mandatory Audit Firm Rotation' the Best Option?,' <http://www.law.unimelb.edu.au/files/dmfile/OTTAWAYJoanne-MandatoryAuditFirmRotationPaper2.pdf>.

exercise to note their views about what constitutes ideal auditor independence in order to obtain a more complete and thorough understanding of this concept.

2.4.2 Commentary on auditor independence

Esanda Finance in 1997 was a landmark High Court decision in relation to an auditor's duty to third parties.[113] The facts were that Esanda Finance had financed various companies associated with Excel Finance and had suffered a loss as a result.[114] Esanda Finance claimed that the external auditor Peat Marwick Hungerfords had been negligent and that it had relied on the audited accounts of Excel Finance audited by Peat Marwick Hungerfords in its decision to proceed with the financing.[115] This case considered the issue of auditor negligence and the various elements that constituted this including the auditor's duty of care.[116] Although this case did not discuss the issue of auditor independence, in considering whether to extend the liability of the auditor, Justice McHugh considered various factors that could potentially encourage the auditor 'to be more diligent in the execution of their statutory obligations'.[117] Justice Gummow acknowledged that 'the auditing process involves more than the statement of verifiable fact.' Rather, 'it is a complex process involving the formulation of a professional opinion'.[118] This thesis submits that judicial commentary such as these have paved the way for legal reform to be explored by policy makers in the area of auditor independence.

In the ***Deo*** case in 2005 Chief Justice Martin of the Northern Territory Supreme Court although not called upon to decide on the issue of auditor independence, indirectly supported the use of auditing standards which required the auditor to be independent in both mind and in appearance.[119] Deo's application to be admitted as a legal practitioner in the Northern Territory was refused on the grounds that Deo had not provided the Supreme Court with full disclosure of ASIC's reprimand concerning Deo's conflict of interest in his capacity as auditor of Balangarri Aboriginal Corporation.[120] Prior to Deo's

[113] *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 23 ACSR 71, 71.
[114] Ibid.
[115] Ibid.
[116] Ibid.
[117] Ibid 73.
[118] Ibid 73.
[119] *In the Matter of An Application by Deo* [2005] NTSC 58.
[120] Ibid.

application, Deo had been an auditor and had audited the financial statements of this corporation whilst conducting an import business with the CEO of the corporation.[121] ASIC referred to auditing standards which required auditors to be both independent in mind and in appearance.[122] ASIC concluded that Deo had failed to appear to be independent as a result of his business dealings with the CEO whilst auditing the financial statements of the corporation.[123] Chief Justice Martin held that Deo 'displayed a lack of judgment and a lack of appreciation of the requirement that an auditor be entirely independent of an organisation in respect of which he was conducting an audit.'[124]

In a more recent case in 2011 Senior Member Walsh in ***Re Confidential*** affirmed that the code of ethics of the respective Accounting Association to which the auditor is a member will be used to determine whether or not the auditor is independent.[125] These codes specifically require that for the auditor to be independent, the auditor must be both independent in mind and in appearance.[126] In ***Re Confidential***, the applicant was the auditor of three self-managed superannuation funds in which the applicant was also either a director of the corporate trustee of the funds, a member of the funds and/or the tax agent for the funds.[127] The applicant sought review by the Administrative Appeals Tribunal of the Commissioner of Taxation's decision disqualifying him from being an auditor for (amongst other things) failing to maintain professional independence.[128] Senior Member Walsh concluded that these circumstances gave rise 'to a lack of independence of appearance, if not a lack of independence of mind' and as a result the auditor had failed to comply with his independence obligations in the code of ethics.[129]

According to Justice Owen, the courts have not had much opportunity to decide on the issue of audit independence.[130] This is because the cause of action for breach of the

[121] Ibid.
[122] Ibid.
[123] Ibid.
[124] Ibid.
[125] *Re Confidential and Commissioner of Taxation* [2011] AATA 403.
[126] Ibid.
[127] Ibid.
[128] Ibid.
[129] Ibid.
[130] The HIH Royal Commission, above n 3.

auditor's duty is normally associated with the incompetence of the external auditor rather than the lack of auditor independence.[131]

The HIH Report acknowledged the difficulty of proving whether an auditor is truly independent.[132] The HIH Report did not conclude that the independence of the external auditor (Andersen) was impaired.[133] All it found was that there were circumstances which gave rise to the perception that Andersen was not independent of HIH.[134] These circumstances included three former Andersen partners who were on the board of HIH at the relevant time, former Andersen partners who had close working relationships with HIH management and in the case of Cohen (a former Andersen partner), who continued to receive benefits from Andersen, (amongst other things) consultancy fees, whilst in his capacity as chairperson of the board of HIH.[135]

Justice Owen was of the view that the difficulties associated with proving whether an auditor is truly independent stem from the nature of auditing.[136] As the audit process is generally conducted outside of the sight of the users of financial statements, 'the users of the financial statements are not privy to the information that is received by the auditor or the process by which the auditor exercises skill and judgment to reach conclusions on that information.'[137] As a result, significant reliance is placed upon the integrity of auditors.[138] This reliance creates the need for auditors to not only be independent in mind but that auditors need to be perceived (by the users of the financial statements) to be independent.[139] The HIH Report acknowledged that in addition to actual independence, the perception that the external auditor is independent 'adds value to capital market efficiency because it enhances the credibility of financial statements.'[140]

In considering what the appropriate standard of audit independence should be, Justice Owen referred to the (then existing) law in relation to (amongst other things)

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[131] Ibid.
[132] Ibid.
[133] Ibid.
[134] Ibid.
[135] See generally, The HIH Royal Commission, above n 3, Chapter 21, paragraphs 21.4.3 and 21.6.1.
[136] Ibid Vol 1, [7.2.1].
[137] Ibid.
[138] Ibid.
[139] Ibid.
[140] Ibid.

'fiduciary obligations' and 'the disqualification of members of the judiciary on the grounds of bias or apprehended bias'.[141]

Justice Owen put forward a measure of independence which draws on fiduciary obligations.[142] He highlighted the explanation given by Chief Justice Gibbs in ***Hospital Products*** that a fiduciary duty is created when a person undertakes to act 'in the interests of another' and 'is entrusted with the power to affect those interests'.[143] In these circumstances the person whose interests have been entrusted, is vulnerable to the abuse of power of the other.[144] Justice Owen also referred to Justice Deane's judgment in ***Chan v Zacharia*** which held that a person who owes a fiduciary duty can receive a benefit or gain despite there being a conflict of interest between that person's fiduciary duty and his/her personal interest as long as this benefit or gain is disclosed to the person to whom the fiduciary duty is owed.[145]

Similarities can be drawn from Justice Owen's measure of independence that referred to the disclosure of the benefit or gain received in Justice Deane's judgement in ***Chan v Zacharia*** and the existing CLERP 9 requirement for listed companies to disclose non-audit services.[146] The *Corporations Act 2001* (Cth) referred to as Corporations Act stipulates that the respective company's annual report must disclose details of the amounts paid or payable to the auditor for non-audit services provided and that the listed entity's board of directors must state in the company's annual report that the provision of the non-audit services does not compromise the auditor independence requirements of the Corporations Act.[147] As in ***Chan v Zacharia***, the Corporations Act requires the entity to disclose the benefit or gain received by the auditor for non-audit services provided to the entity including the amounts paid or payable to the auditor.[148] The Corporations Act however takes this one step further in that the entity is not only required to disclose the benefit or gain received by the auditor but that the entity's board of directors have to state

[141] Ibid.
[142] Ibid.
[143] The HIH Royal Commission, above n 3 and *Hospital Products Ltd v United States Surgical Corporation* (1984) 55 ALR 417, 432.
[144] *Hospital Products Ltd v United States Surgical Corporation* (1984) 55 ALR 417, 432.
[145] The HIH Royal Commission, above n 3 and *Chan v Zacharia* (1983) 53 ALR 417, 433.
[146] *Chan v Zacharia* (1983) 53 ALR 417, 433 and Corporations Act s300(11B).
[147] Corporations Act s300(11B).
[148] *Chan v Zacharia* (1983) 53 ALR 417, 433 and Corporations Act s300(11B).

that the provision of the non-audit services does not compromise auditor independence.[149]

Austin and Ramsay have sought to distinguish the current statutory requirement for auditors of a 'conflict of interest situation' from the law of fiduciary obligations.[150] In their view the law of fiduciary obligations considers whether 'the circumstances of actual or possible conflict between personal interest and fiduciary duty are present and will intervene accordingly to prevent the possibility that interest will be preferred to duty, in the absence of fully informed consent by the principal.'[151] On the other hand, the current statutory requirement for auditors outright prohibits the auditor from acting for the auditee where a 'conflict of interest situation' exists.[152] This can occur if the auditor is not independent in mind or in appearance.[153] They are however of the view that the auditor's fiduciary obligations still exist in addition to the current statutory requirement as explained above.[154]

This thesis supports the view of Austin and Ramsay in that the current statutory requirement of a 'conflict of interest situation' is different from the law of fiduciary obligations in its interpretation as well as its application as discussed above. As a consequence, the law of fiduciary obligations does not assist much in the determination of what constitutes ideal auditor independence.

Justice Owen was of the view that the measure of independence for auditors should 'be adapted from the test laid down to determine whether a judge is disqualified by reason of the appearance of bias.'[155] This is because according to Justice Owen, although 'judges and auditors perform different functions, there is a common element' in that 'both functions involve an exercise of judgment which results in the public expression of an important opinion which is capable of affecting society widely.'[156] Justice Owen referred to ***Johnson v Johnson*** which specified that the test to determine whether a judge is bias

[149] Corporations Act s300(11B).
[150] Robert Austin and Ian Ramsay, Ford's Principles of Corporations Law (Lexis Nexis Online) [11.455.5].
[151] Ibid.
[152] Ibid.
[153] Ibid.
[154] Ibid.
[155] The HIH Royal Commission, above n 3.
[156] Ibid.

is 'whether a fair-minded lay observer might reasonably apprehend that the judge might not bring an impartial and unprejudiced mind to the resolution of the question the judge is required to decide.'[157]

This thesis does not accept Justice Owen's view that the test for auditor independence should be adapted from the test to determine whether a judge is biased on the basis of the common element shared by the two professions as discussed above. Despite there being a 'common element' in that 'both functions involve an exercise of judgment which results in the public expression of an important opinion which is capable of affecting society widely',[158] their respective responsibilities are nevertheless very different and so are the consequences of their respective decisions.

Judges may have the ability to sentence guilty individuals with severe penalties that in some circumstances can result in life imprisonment for the individual. As these consequences can severely restrict the freedom of the individual, judges must be seen to be impartial whilst deciding on these matters. The auditor on the other hand is generally appointed by the auditee to ensure that the audited financial statements of the auditee provide a true and fair view of the financial position of the auditee. The failure of the auditor to accomplish this can cause the users of financial statements to suffer financial loss. Financial loss is not the same as the loss of freedom and/or life. On this view, the same test for judges should not be applied to auditors.

The appointments of judges and auditors are significantly different. The constitution provides that judges once appointed generally cannot be removed from their office until they reach the age of 70.[159] They can only be removed on the grounds of proven misbehaviour or incapacity.[160] Their salaries whilst in office cannot be reduced.[161] Auditors on the other hand are appointed by shareholders during the company's annual general meeting and their appointment is subject to annual renewal by the shareholders at the next company's annual general meeting.[162] Their remuneration for the next year is not

[157] Ibid and *Johnson v Johnson* (2000) 174 ALR 655, 658.
[158] The HIH Royal Commission, above n 3.
[159] *Australian Constitution* s 27.
[160] Ibid s 27 (ii).
[161] Ibid s 27 (iii).
[162] Corporations Act 328B.

assured. As the auditor is dependent on the company for his/her remuneration,[163] this uncertainty is a threat to the independence of the external auditor as a consequence of the self-serving bias discussed in Section 2.4.4 of this thesis. On this view as well, the same test for judges should not be applied to auditors.

This thesis rejects Justice Owen's view that the common element shared by the two professions provides justification that the test for auditor independence should be adapted from the test to determine whether a judge is biased. This thesis however accepts that the test for auditor independence can be adapted from the test to determine whether a judge is biased on the basis that this test for judges seeks to enhance the appearance of independence. This is because ideal auditor independence can be enhanced when auditors are independent in both mind and appearance. The reason for this is attributed to the multifaceted nature of auditor independence as explained in Section 2.4.3 and not on the basis of the common element shared by judges and auditors as discussed above. On this view, it seems appropriate that a similar standard has been adopted in the codes of conduct of the Accounting Associations.[164] These codes stipulate that auditors not only be independent in mind but also independent in appearance.[165] The requirement that auditors be independent in appearance is similar to the standard required for judges in that a fair-minded lay observer must be able to conclude that the action or conduct in question of the auditor is independent.[166]

As the above commentaries do not provide much guidance as to what constitutes ideal auditor independence, literature on the multifaceted nature of auditor independence is examined in the following section to assist in providing clarity to the meaning of ideal auditor independence.

[163] It may well be that due to financial pressures to retain existing clients, an audit partner can be faced with conflicting interests that can compromise independence. This self-serving biased is explained in Section 2.4.4. In these circumstances, the number of clients that an audit firm has (for example in larger audit practices) may not necessarily alleviate the financial pressures faced by the audit partner. These financial pressures can still be considered as threats to the independence of the external audit.
[164] Accounting Professional & Ethical Standards Board, *Code of Ethics for Professional Accountants APES 110* (2013) Section 290.6.
[165] Ibid.
[166] Ibid and *Johnson v Johnson* (2000) 174 ALR 655, 658.

2.4.3 The various facets of independence

This section will discuss the compartmentalization of the various facets of independence. In order to analyse the implications for auditor independence, an understanding of the various facets of independence is needed. It is necessary to understand what these key concepts mean. It is only when this is accomplished, can focused efforts be made to address any inadequacies found in the current regime in relation to ideal auditor independence.

According to Michael Power, independence can be divided into 'organizational independence' and 'operational independence'.[167] He has stated that 'organizational independence' concerns 'the independence of the individual auditor and the profession' and 'operational independence' refers to 'the immanent ability of auditing to be independent.'[168]

Power has further segregated 'organizational independence' into 'independence in fact' and 'independence in appearance' and 'operational independence', into 'informational independence' and 'epistemic independence'.[169] In his view, 'informational independence' relates to 'the problem with auditing's fundamental dependence on information supplied by the auditee.'[170] According to Power, 'epistemic independence' means the 'knowledge upon which the conclusions of the audit is built must be independent.'[171]

Independence in fact means that the external auditor has to be independent in mind.[172] This involves 'the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.'[173]

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[167] See generally, Michael Power, *The Audit Society: Rituals of Verification* (Oxford University Press, 1st ed, 1997) 131-134.
[168] Ibid.
[169] Ibid.
[170] Ibid.
[171] Ibid.
[172] The definitions of independence in mind and appearance respectively can be found in CPA Australia and Institute of Chartered Accountants in Australia, *Professional Statement F1 Professional Independence* (2006) paragraph 14, Accounting Professional & Ethical Standards Board, *Code of Ethics for Professional Accountants APES 110* (2013) Section 290.6 and Corporations Act s324CD(1)(b).
[173] The definitions of independence in mind and appearance respectively can be found in CPA Australia and Institute of Chartered Accountants in Australia, *Professional Statement F1 Professional Independence*

Independence in appearance means that the auditor must be seen to be independent.[174] Put simply, a reasonable person must be able to conclude that the action or conduct in question of the auditor is independent.[175] As such, in order for an auditor to be independent from the 'organizational independence' perspective, the auditor must not only be independent in mind but must also be perceived by the general public to be independent.[176]

A decision in itself to deliberately channel efforts to address ideal auditor independence inadequacies in the current regime is not going to be workable unless ideal auditor independence is first defined. The next section is dedicated to this, in order for practical legal reform to be consistent with the public interest.

2.4.4 Ideal auditor independence

This section will discuss what ideal independence is and why it may be impossible to achieve ideal independence. Critical to the development of auditor independence legal reform is an understanding of what ideal auditor independence is. This section considers what this term means and concludes that ideal auditor independence is impossible to attain in the area of 'operational independence'. However, the concept of ideal auditor independence can still be promoted within existing arrangements in the area of 'organizational independence'.

Ideal auditor independence means that the external auditor must be totally independent from the client in the preparation and the subsequent issue of the audit

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(2006) paragraph 14, Accounting Professional & Ethical Standards Board, *Code of Ethics for Professional Accountants APES 110* (2013) Section 290.6 and Corporations Act s324CD(1)(b).

[174] The definitions of independence in mind and appearance respectively can be found in CPA Australia and Institute of Chartered Accountants in Australia, *Professional Statement F1 Professional Independence* (2006) paragraph 14, Accounting Professional & Ethical Standards Board, *Code of Ethics for Professional Accountants APES 110* (2013) Section 290.6 and Corporations Act s324CD(1)(b).

[175] The definitions of independence in mind and appearance respectively can be found in CPA Australia and Institute of Chartered Accountants in Australia, *Professional Statement F1 Professional Independence* (2006) paragraph 14, Accounting Professional & Ethical Standards Board, *Code of Ethics for Professional Accountants APES 110* (2013) Section 290.6 and Corporations Act s324CD(1)(b).

[176] The definitions of independence in mind and appearance respectively can be found in CPA Australia and Institute of Chartered Accountants in Australia, *Professional Statement F1 Professional Independence* (2006) paragraph 14, Accounting Professional & Ethical Standards Board, *Code of Ethics for Professional Accountants APES 110* (2013) Section 290.6 and Corporations Act s324CD(1)(b).

report. It is submitted that ideal auditor independence can only be achieved when the auditor has ‘organizational independence’ and ‘operational independence’.

For the reasons given below, this thesis acknowledges that ‘operational independence’ cannot be attained. Notwithstanding this, this thesis seeks to improve auditor independence in the area of ‘organizational independence’ with the objective of promoting the public interest. Despite the impossibility of achieving ideal auditor independence nevertheless the public interest can still be enhanced when mechanisms are developed to support this public interest objective in the area of ‘organizational independence’.

This thesis does not seek to propose changes to the way in which the process of auditing is carried out. As a result, proposals that can promote ‘operational independence’ are not considered.

Changes that support ‘informational independence’ would require the auditor to obtain the requisite financial information concerning the auditee directly from its source, without having to rely on the auditee’s management for the information. This cannot be practically achieved as a significant amount of time would need to be spent by the auditor to independently collate the requisite information. This exercise would change the very nature of auditing and would cause additional audit fees to be incurred that would be difficult to justify. For example, instead of requesting the management of a listed retail entity to provide the auditor with a listing of its inventory and the respective values of such inventory, the auditor would then have to consult an independent valuer to provide an independent valuation of the inventory. It is anticipated that such an exercise will cause audit fees to increase significantly to such an extent that it will not be financially viable for either the auditor or the auditee, depending on who will bear this additional cost, to conduct the audit.

Likewise, the current institutional arrangements which exist between the auditor and the auditee, prevent ‘epistemic independence’ from becoming a reality. ‘Epistemic independence’ can only be held as an ideal for as long as the external auditor is dependent on the client for audit fees. This independence can be impaired when the auditor’s knowledge base is influenced by the auditor’s self-serving bias.

Various commentators[177] have claimed that it is psychologically impossible for an auditor to be free from bias. This is because auditors are paid by the very same clients for whom they audit and prepare an audit report.

According to Bazerman, Morgan and Loewenstein, the need for self-preservation inherent in auditors as a result of the auditor and client relationship has the potential to influence the way in which auditors process information.[178] This may cause honest auditors to unknowingly and gradually make marginal decisions in their client's favour.[179] Widely defined financial reporting standards provide this opportunity.[180] At some stage, this can result in a material misrepresentation of facts which can lead to an inappropriate audit report being issued.[181] As this is unintentional, the threat of sanctions is unlikely to prevent this from occurring.[182]

One way to overcome this is for the listed entity auditor to be appointed and remunerated by an independent entity such as a government agency. This however would be unacceptable for the taxpayer who may have to remunerate the auditor. Alternatively a levy could be imposed on listed entities. The amount of levy to be contributed by each company could be based on the market capitalisation of the company. The contributions collected from this levy can form a common pool to be utilised by the independent entity to remunerate the external auditors for their respective audit services. This would be unacceptable for the larger listed entities as these entities will lose their right to negotiate directly with the external auditor for reduced audit fees.

This section identifies that 'organizational independence' being independence in fact and in appearance can enhance auditor independence. Mechanisms can be designed with the purpose of supporting these two facets of independence. This thesis acknowledges that ideal auditor independence cannot be achieved as the way in which auditing is conducted and the current institutional arrangements for auditing prevent 'informational independence' and 'epistemic independence' from being fully realised.

[177] See generally Max Bazerman, Kimberly Morgan and George Loewenstein, 'The Impossibility of Auditor Independence' (Summer,1997) *Sloan Management Review* 89, 90.
[178] Ibid.
[179] Ibid 93.
[180] Ibid.
[181] Ibid.
[182] Ibid 94.

This thesis however seeks to enhance ideal auditor independence by proposing legal reform that has the potential to promote 'organizational independence' being independence in fact and in appearance.

Now that a definition of the public interest has been established to evaluate the current regime, the significant auditor independence requirements in CLERP 9 can be critically analysed in order to identify potential areas for legal reform specifically in relation to organizational independence where this ideal is found to be inadequate. This way, the public interest can be advocated.

The subsequent paragraphs introduce the significant CLERP 9 reforms that were implemented by the government in response to high profile corporate collapses such as HIH and One.Tel.[183] The next section provides a summary of these legal reforms which were introduced with the sole purpose of addressing auditor independence concerns. These legal reforms can be found in the Corporations Act. The ASX Corporate Governance Principles are introduced in Section 2.7 because they have the potential to complement CLERP 9 in supporting ideal auditor independence. The public interest can be promoted when these two mechanisms work seamlessly together in their respective efforts to enhance ideal auditor independence. The existing framework for auditor independence in place within these principles can be developed to complement proposals for legal reform pursuant to CLERP 9.

Chapter 5 analyses whether these CLERP 9 reforms were developed with the public interest CLERP objective in mind. As ideal auditor independence is consistent with the public interest, Chapter 5 analyses whether these CLERP 9 reforms are consistent with ideal auditor independence. Proposals for legal reform in the area of organizational independence are introduced in Chapter 5 in circumstances where ideal organizational independence is found to be inadequate.

[183] Chapple and Koh, above n 3, See generally, Ramsay, above n 3, Armstrong, above n 3, George, above n 3 and The HIH Royal Commission, above n 3.

2.5 SIGNIFICANT CLERP 9 REFORMS

CLERP 9 was the government's response to the corporate collapses of HIH and One.Tel in early 2000.[184] The corporate collapses of HIH and One.Tel initiated public outcry in relation to (amongst other things) the independence of external auditors.[185] The external auditors of HIH and One.Tel provided both audit and non-audit services to their respective clients.[186] The recurring fees received for these services were considered to be significant enough to pose a threat to the independence of the external auditors.[187] It was alleged that these fees had impaired the judgement of the auditors in the issuing of the respective auditor's report.[188] Questionable accounting practices condoned by the external auditors for both HIH and One.Tel allowed these entities to show a profit whilst millions of dollars of losses were hidden from public scrutiny.[189] At the time of HIH's collapse, two board members of HIH were also ex-partners of HIH's external auditors.[190] The existence of this relationship posed another threat to independence.[191]

As a consequence of these corporate collapses, Professor Ian Ramsay was requested by the government, in 2001, to review the then existing auditor independence requirements in Australia. Professor Ramsay provided the Ramsay Report to the government in the same year.[192] The Ramsay Report contained (amongst other things) recommendations that could enhance the then existing auditor independence requirements.[193]

Subsequent to the issue of the Ramsay Report, a report was also compiled by the government's Joint Committee of Public Accounts and Audit.[194] This report titled

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[184] Chapple and Koh, above n 3, See generally, Ramsay, above n 3, Armstrong, above n 3, George, above n 3 and The HIH Royal Commission, above n 3.
[185] Chapple and Koh, above n 3, See generally, Ramsay, above n 3, Armstrong, above n 3, George, above n 3 and The HIH Royal Commission, above n 3.
[186] De Martinis, above n 2 and von Nessen, above n 4.
[187] De Martinis, above n 2 and von Nessen, above n 4.
[188] De Martinis, above n 2 and von Nessen, above n 4.
[189] Tom Campbell and Keith Houghton, *Ethics and Auditing* (ANU E Press, 1st ed, 2005) 171.
[190] The HIH Royal Commission, above n 3.
[191] Ibid.
[192] Ramsay, above n 3, 114.
[193] Ibid 7-19.
[194] Joint Committee of Public Accounts and Audit, *Media Release 18 September 2002* <http://www.aph.gov.au/Parliamentary_Business/Committees/House_of_Representatives_Committees?url=jcpaa/indepaudit/contents.htm>.

'Review of Independent Auditing by Registered Company Auditors' was released in September 2002 and contained 13 recommendations.[195] The report was based on a review of the independent audit function conducted by company auditors. [196]

In addition, a Royal Commission was established by the government to investigate the HIH collapse.[197] Justice Owen headed the Royal Commission and he delivered his report to the government in 2003.[198] Included in this report were law reform proposals in relation to auditor independence.[199]

The proposals for auditor independence law reform contained in the Australian government's discussion paper, titled 'Corporate Disclosure: Strengthening the Financial Reporting Framework' (referred to in this thesis as "**Relevant Proposals**") were released by the Treasury in 2002 for public consultation.[200] This discussion paper contained legislative proposals for (amongst other things) auditor independence law reform.[201] More than 60 submissions were received in response to the Treasury public consultation process in relation to the Relevant Proposals. These submissions were analysed for the purposes of this thesis.

The CLERP 9 Bill was circulated by the Treasury in 2003 for public consultation.[202] A total of 60 submissions were received in response to the Treasury public consultation process. The JPCCFS also invited public submissions on the CLERP 9 Bill and they received over 60 submissions.[203] CLERP 9 was introduced into law on 1 July 2004.[204] For the purposes of this thesis, these submissions were examined.

The significant CLERP 9 reforms in relation to auditor independence can be categorized and divided into two broad areas. The first is a general requirement for auditor independence and the second being specific requirements for auditor independence. These are discussed under their respective headings below.

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[195] Ibid.
[196] Ibid.
[197] The HIH Royal Commission, above n 3.
[198] Ibid.
[199] Ibid.
[200] Treasury, above n 26.
[201] Ibid.
[202] du Plessis, McConvill and Bagaric, above n 5, 160.
[203] Ibid.
[204] Ibid.

2.5.1 General requirement for auditor independence

Part 2M.4 Div 3 Subdiv A section 324CA of the Corporations Act stipulates a general requirement for auditor independence. This took effect from 2004 and was part of the government's auditor independence law reform in response to the corporate collapses of HIH and One.Tel in early 2000.[205] It prohibits the auditor from auditing the auditee where a 'conflict of interest situation' exists at the time the audit activity occurs.[206] There is a contravention of section 324CA(1A) where the auditor after being aware that the 'conflict of interest situation' exists does not, within seven days, ensure that the 'conflict of interest situation' ceases to exist or notify ASIC in writing that it exists.[207]

Section 324CD(1) states that a 'conflict of interest situation' exists in circumstances where the ability of the auditor to exercise 'objective and impartial judgment' may be compromised or where 'a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor' 'is not capable of exercising objective and impartial judgment in relation to the conduct of the audit'.[208] This means that as long as a reasonable person is of the view that the auditor 'is not capable of exercising objective and impartial judgment' a 'conflict of interest situation' exists for the purposes of the Corporations Act. A conflict of interest need not have to actually occur in order for there to be a contravention.

An 'individual auditor' contravenes section 324CA(2) if the auditor 'engages in audit activity in relation to an audited body at a particular time' and 'a conflict of interest situation exists in relation to the audited body', even though the auditor 'is not aware that the conflict of interest situation exists'.[209] In those circumstances, a contravention occurs if the auditor 'would have been aware of the existence of the conflict' had there been 'in place a quality control system reasonably capable of making the individual auditor' 'aware of the existence of such a conflict'.[210] The auditor however does not contravene this section if the auditor had 'reasonable grounds to believe' that there was 'in place at

[205] De Martinis, above n 2.
[206] Corporations Act s324CA(1).
[207] Ibid.
[208] Ibid s324CD(1).
[209] Ibid s324CA(2).
[210] Ibid.

that time a quality control system that provided reasonable assurance (taking into account the size and nature of the audit practice)' that the auditor had complied with the requirements of the corporations law.[211]

2.5.2 Specific requirements for auditor independence

In addition to the general standard of auditor independence, various provisions in the Corporations Act such as Part 2M.4 Div 3 Subdiv B sections 324CE-324CK provide for specific independence requirements designed to enhance auditor independence. Some of these are relevant to the discussion in Chapter 5 as these mechanisms either encourage the auditor to be independent in mind and/or promote the appearance of independence. For these reasons they are briefly introduced under the sub-headings Declarations, Relationships, Disclosure, Rotation and Notifications in the following paragraphs.

Declarations

The Corporations Act requires an auditor to give the directors of a company, a written declaration that, to the best of the auditor's knowledge, the auditor has not contravened any of the auditor independence requirements of the Corporations Act and any applicable code of professional conduct.[212] This applies to an auditor who conducts an audit of the financial report for a full financial year or a half financial year.[213] The annual directors' report and the directors' half-year report must include a copy of the auditor's independence declaration made under s307C.[214]

Relationships

The significance of relationships as a threat to auditor independence is reflected in the Corporations Act. It prohibits the auditor from engaging in prescribed employment and financial relationships.

[211] Ibid s324CA(4).
[212] Ibid s307C(1).
[213] Ibid.
[214] Ibid s298(1AA) and s306(1A).

Employment Relationships

Section 324CI prohibits a person from becoming an officer of the audited body for two years where the person ceases to be a member of an audit firm or director of an audit company and was a professional member of the audit team for the audit.[215] The same prohibition of two years also extends to a professional employee of the audit firm where the person was a 'lead auditor' or 'review auditor' for the audit of the audited body.[216] A 'lead auditor' is the registered company auditor who is primarily responsible to the audit firm or the audit company for the conduct of the audit.[217] A 'review auditor' is the registered company auditor (if any) who is primarily responsible to the individual auditor, the audit firm or the audit company for reviewing the conduct of the audit.[218]

Financial Relationships

An individual auditor is prohibited from engaging in audit activity with the audited body in circumstances where the auditor has entered into a financial relationship as set out in the table in s324CH(1) with the audited body at a particular time. For example, an individual auditor must not engage in audit activity with the audited body where the auditor has an investment in the audited body, owes an amount of money to the audited body or is owed an amount of money by the audited body unless exempted by the Corporations Act in certain circumstances.[219]

Disclosure

Listed companies are required to disclose non-audit services that have been provided, in the respective company's annual report pursuant to section 300(11B). The information to be disclosed includes details of the amounts paid or payable to the auditor for non-audit services provided and a statement from the listed entity's board of directors stating that the provision of the non-audit services does not compromise the auditor independence requirements of the Corporations Act.[220] This information must be included in the directors' report to be identified under the heading "Non-audit

[215] Ibid s324CI.
[216] Ibid s324CJ.
[217] Ibid s324AF.
[218] Ibid.
[219] Ibid s324CE(1).
[220] Ibid s300(11B).

services".[221] If the listed entity has an audit committee, the directors' statement that the provision of the non-audit services does not compromise the auditor independence requirements of the Corporations Act must be made in accordance with advice provided by the listed entity's audit committee.[222]

Rotation

The Corporations Act prohibits an individual auditor who has acted as an external auditor for the listed company for five successive financial years from continuing to act as an external auditor for that company for at least another two successive financial years.[223]

These rotation requirements are limited to the lead engagement and review partners.[224] As explained in the Explanatory Memorandum, this is because the lead engagement and review partners, 'are responsible for the audit opinion and have the ability to control the work of other members of the engagement team.' 'It is at this level that independence concerns are greatest.'[225] The reliability of the audit opinion can be questioned in circumstances where the independence of these key people is (and/or perceived to be) compromised. This is because the lead engagement and review partners have the ability to influence the work flow of the audit team and ultimately the outcome of the audit which culminates in the audit opinion.

Notifications

CLERP 9 has expanded auditors' duties to include notifications to ASIC in circumstances where the independence of the external auditor may be compromised.

Section 311 requires an individual auditor conducting an audit to notify ASIC in writing within 28 days after the auditor becomes aware of any circumstances (amongst

[221] Ibid.
[222] Ibid s300(11D).
[223] Ibid s324DA .
[224] Ibid s9.
[225] Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) para 4.53.

other things) that amount to an attempt, in relation to the audit, by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit.[226]

Section 311 is comprised of two limbs. The first consists of the auditor's duty to notify ASIC in circumstances where the conduct of the officer(s) of the auditee can be construed as being a threat to the independence of the auditor. The second involves the time period (being 28 days) within which such notification to ASIC is required to be made.

As this thesis is concerned with auditor independence, only the first limb of section 311 in relation to the relevant submissions will be analysed and discussed. This is because any attempt by the officer of the auditee that is perceived to be a threat to the independence of the auditor can potentially invoke this section. The first limb was expressly stated in the Relevant Proposals and its relevance to auditor independence was the rationale for the decision to subject it to detailed analysis in this thesis.

The second limb on the other hand refers to the time period in which the auditor is required to notify ASIC after the auditor becomes aware of such an incident. This time period regardless of its duration poses no threat to the independence of the auditor and as a consequence has no bearing on the independence of the auditor. For this reason, the second limb was excluded from analysis. It is also noted that the second limb was not expressly stated in the Relevant Proposals and that it was introduced by the government at a later stage when the Relevant Proposals were being fine-tuned for practical application.

2.6 POST-CLERP 9 LEGISLATIVE AMENDMENTS

It was not until 2010 that a review of the auditor independence requirements in CLERP 9 was undertaken by the government. The reason for this may well have been a lack of high profile corporate collapses during this period which could have prompted the government to take urgent action to re-evaluate the existing auditor independence requirements. However, as a result of the global financial crisis, the Treasury (in March

[226] Corporations Act s 311.

2010) completed a strategic review of audit quality in Australia. Treasury completed its consultations with key stakeholders by holding roundtable discussions with stakeholders in November 2010. It is important to note that only key stakeholders attended these consultations. These stakeholders were not identified. These consultations seem to be to a closed group. It is arguable that the proposals raised during these roundtable discussions were not representative of all stakeholders as only some stakeholders were present during these discussions. A number of important legislative proposals were identified during this 'consultative process'. These included proposals to amend the existing oversight powers of the FRC in relation to auditor independence[227] and the auditor rotation requirements[228] in the current regime. The government proposed to progress these reforms through the Audit Enhancement Bill.[229]

On 30 September 2011, the Treasury released an exposure draft of the Audit Enhancement Bill together with the relevant commentary for public consultation. This thesis analyses the submissions which were received in response to the Treasury public consultation process. These submissions were made in response to proposals to amend the existing oversight powers of the FRC in relation to auditor independence and the auditor rotation requirements in the current regime. These proposed reforms comprised a range of measures to enhance audit quality in Australia and were introduced into law in June 2012.[230]

CLERP 9 provided the FRC with the power to directly monitor auditor independence.[231] The *Corporations Legislation Amendment (Audit Enhancement) Act 2012* (Cth) referred to as Audit Enhancement Act delegated this power to ASIC.[232] This move removed the duplication[233] between the 'operational' nature of the FRC's previous function and ASIC's audit inspection program.

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[227] Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) 8.
[228] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 4.
[229] Ibid.
[230] See generally, Audit Enhancement Act.
[231] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[232] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[233] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 9.

CLERP 9 prohibited the lead audit engagement and review partners from continuing to act as an external auditor for a listed company for at least another two successive financial years in circumstances where the lead audit engagement and review partners have acted as external auditor for the listed company for five successive financial years.[234] The Audit Enhancement Act enables the lead audit engagement and review partners to continue to audit the listed company for up to a further two years provided requirements are satisfied in relation to the safeguarding of audit quality and auditor independence.[235]

This thesis analyses the collated submissions from the Treasury in relation to the Relevant Proposals, CLERP 9 Bill and the Audit Enhancement Bill public consultation process and the collated submissions from the JPCCFS in relation to the CLERP 9 Bill public consultation process.

2.7 ASX CORPORATE GOVERNANCE PRINCIPLES

As stated previously, the ASX Corporate Governance Principles were not part of CLERP. The ASX Corporate Governance Principles however can be developed to enhance auditor independence in addition to CLERP 9. This way, the existing framework within the ASX Corporate Governance Principles can potentially complement CLERP 9 in supporting ideal auditor independence.

The Council was formed in August 2002 'as a central reference point for companies to understand stakeholder expectations and to promote and maintain investor confidence.'[236] It has stated that its purpose is 'to develop principles and recommendations which reflect international good practice.'[237] The Council has the potential to develop principles and recommendations that can potentially enhance the

[234] Corporations Act s324DA .
[235] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 4 and Audit Enhancement Act Schedule 1 Part 1 item 7.
[236] Australian Securities Exchange, *Second edition – Revised Corporate Governance Principles and Recommendations 2007* <http://www.asx.com.au/about/corporate_governance/revised_corporate_governance_principles_recommendations.htm>.
[237] Ibid.

independence of the company's external auditors. This can be achieved by, for example, extending the existing responsibility of audit committees of ASX listed companies in order to support such an outcome. The Council has claimed that it represents '21 business, investment and shareholder groups.'[238] It has stated that its objective is 'to ensure that the principles-based framework it developed for corporate governance continues to be a practical guide for listed companies, their investors and the wider Australian community.'[239]

As the ASX Corporate Governance Principles were designed with the objective to broadly improve the corporate governance of listed companies, the Council has the ability to influence the development of principles and recommendations in relation to auditor independence specifically. The role of these guidelines will be revisited in Chapter 5 where recommendations which can further enhance auditor independence are proposed.

In March 2003, the Council issued 10 corporate governance principles and 28 specific recommendations for implementing those principles (collectively referred to as the ASX Corporate Governance Principles).[240] An extensive review of these principles and recommendations was subsequently undertaken between November 2006 and February 2007.[241] On 2 August 2007, the Council issued revised ASX Corporate Governance Principles (known as the second edition of the ASX Corporate Governance Principles) with the effective date being the listed entity's first financial year commencing on or after 1 January 2008.[242]

By 2011, the Council completed another review of the ASX Corporate Governance Principles. The purpose of the review was to ascertain whether the existing ASX Corporate Governance Principles was adequate or whether there was a need to amend the

[238] Ibid.
[239] Ibid.
[240] Australian Securities Exchange, *First edition – Principles of Good Corporate Governance 2003* <http://www.asx.com.au/about/corporate_governance/principles_good_corporate_governance.htm>.
[241] Australian Securities Exchange, *Second edition – Revised Corporate Governance Principles and Recommendations 2007* <http://www.asx.com.au/about/corporate_governance/revised_corporate_governance_principles_recommendations.htm>.
[242] Ibid.

second edition and to issue a third edition.[243] The review involved consultations with various stakeholders which included 'representatives of directors, management, institutional and retail shareholders, proxy advisers and others with an interest in the development of corporate governance practices.'[244] These consultations did not reveal any inadequacies that would provide justification for amending the ASX Corporate Governance Principles.[245] Instead, the Council obtained consistent feedback that the existing ASX Corporate Governance Principles were practical in application to both large and small companies and 'were structured in a way that enabled businesses of very different sizes to adopt approaches that were simultaneously consistent with the ASX Corporate Governance Principles and yet tailored to the level of complexity of a particular business.'[246]

The Council initiated another review of the ASX Corporate Governance Principles during the second half of 2012 with particular focus on Principle 6 Respect the rights of shareholders, Principle 7 Recognise and manage risk and Principle 8 Remunerate fairly and responsibly.[247] As the focus of the review does not appear to concern auditor independence, it is envisaged that the forthcoming issue of the third edition (scheduled to be issued by the end of 2013 but as at the submission date of this thesis has yet to be issued) will not have an impact on the outcome of this thesis.[248] This thesis examines and proposes legal reform to Principle 4 Safeguard integrity in financial reporting.

The ASX Corporate Governance Principles entrust the responsibility of ensuring the independence of the company's external auditors, on (amongst others) members of the audit committee. Principle 4 details the purpose of the audit committee, which includes focusing the company on particular issues relevant to verifying and safeguarding the integrity of the company's financial reporting.[249]

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[243] Australian Securities Exchange, *ASX Corporate Governance Principles and Recommendations 2011 review* <http://www.asx.com.au/resources/listed-at -asx/new-listing-rule-on-remuneration.htm>.
[244] Ibid.
[245] Ibid.
[246] Ibid.
[247] Australian Securities Exchange, ASX Corporate Governance Council, *Media Release 4 December 2012* <http://www.asxgroup.com.au/media/PDFs/cgc-communique-4dec12.pdf>.
[248] Ibid.
[249] Australian Securities Exchange, Second edition – Revised Corporate Governance Principles and Recommendations 2007

Commentators have suggested that both CLERP 9 and the ASX Corporate Governance Principles complement each other in supporting the good corporate governance practices (including the promotion of auditor independence) of listed companies.[250] Civil and criminal penalties are associated with CLERP 9 contraventions.[251] On the other hand, significant non-compliance with the ASX Corporate Governance Principles can result in the expulsion of the listed entity from being a member of the ASX.[252]

The significant auditor independence reforms in CLERP 9 as well as Principle 4 of the ASX Corporate Governance Principles have been introduced here to provide a legal framework that can be analysed later in this thesis. In circumstances where this legal framework is found to be inadequate, legal reform can be proposed.

2.8 SUMMARY

This thesis evaluates the existing requirements with a view to provide proposals which support ideal auditor independence in the area of organizational independence in circumstances where ideal auditor independence is found to be lacking.

A decision in itself to deliberately channel efforts to address ideal auditor independence inadequacies in the current regime, specifically in relation to organizational independence, is not going to be workable unless ideal auditor independence is first defined. This is the public interest requirement – the ideal measure, that auditors be completely independent against the existing requirements in the current regime. This needs to be established before this thesis can identify ways of practically improving the auditor independence requirements where the current regime is found to be inconsistent with the public interest.

It is acknowledged that in view of the way in which auditing is conducted and the self-serving bias, ideal independence is not achievable under existing arrangements. This study however seeks to enhance ideal independence by proposing legal reform aimed at

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<http://www.asx.com.au/about/corporate_governance/revised_corporate_governance_principles_recommendations.htm>.

[250] du Plessis, McConvill and Bagaric, above n 5, 148.

[251] Ibid.

[252] Ibid.

improving organizational independence with the objective of promoting the public interest.

The circumstances which led to the enactment of CLERP 9 are discussed in this chapter. These events highlight the need for greater auditor independence. In view of this, auditor independence is an important ongoing consideration which has been and will continue to arise from time to time. As such, this issue needs to be regularly reviewed in order for auditor independence legal reform to be consistent with the public interest.

For the purposes of this study, ideal independence can be promoted where auditor independence legal reform is aimed at benefiting the public interest. Such legal reforms should support the primary users' broader economic interests. These interests consist of the economic needs of the primary users of accounting information. The primary users of accounting information comprise individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors.

In the next chapter, the thesis will analyze why private interest theory was selected to evaluate how the current regime emerged. Stakeholders involved in private interest theory will be discussed and their respective motivations to influence the development of the current regime will be explored.

Chapter 3: WHY PRIVATE INTEREST THEORY WAS SELECTED TO EVALUATE HOW THE CURRENT REGIME EMERGED

3.1 INTRODUCTION

The main objective of this thesis is to examine the adequacy of the auditor independence requirements in the Corporations Act against the ideal auditor independence measure. The public interest can be promoted when these requirements are consistent with ideal auditor independence. Private interest theory is applied to determine whether the auditor independence requirements in CLERP 9 were developed to serve private interests rather than the stated goal of the public interest. In that context, this chapter provides an introduction to private interest theory in order to explain how the current regime was established.

In order to determine the most suitable theory to evaluate the current regime, reference is made to the key CLERP principles as discussed in Chapter 2. According to du Plessis, McConvill and Bagaric, these key principles can provide a useful framework for analysing corporate law reforms from the perspective of whether the reforms are consistent with the key principles. This way any inconsistencies between the new legislation and the key principles can be identified for potential future legal reform.[253]

Chapter 2 demonstrated that an objective of CLERP was to promote the public interest.[254] That chapter discussed the concept of the public interest from the perspective of the key CLERP principles. In doing so, it maintained that measures aimed at promoting ideal auditor independence in CLERP 9 can be consistent with the public interest. Chapter 2 stipulates that these measures should comprise mechanisms in CLERP 9 that support independence in mind and independence in appearance.

[253] Ibid 152.
[254] Treasury, above n 6.

This chapter outlines the theory and process that will be used in Chapter 4 to explain how the CLERP 9 regulatory process has been influenced by the lobbying activities of powerful interest groups through the use of private interest theory. This chapter explains what this theory is and develops the framework through which it can be applied in the next chapter.

This chapter is presented in five sections. Section 3.2 looks at the background to the development of the current regime to provide support for the use of private interest theory. Section 3.3 introduces private interest theory as a basis for evaluating the process by which the current regime was arrived at. Section 3.4 explains how private interest theory can be used to examine the development of the current regime and provides an overview as to how this theory has been used by various commentators to explain the regulatory process. In applying this theory Section 3.5 identifies the various interest groups to be examined in Chapter 4. It is argued that to the extent that the development of the regulation of audit independence has been dominated by private interests, the stated goal of the public interest may not be achieved. Section 3.6 sets out the reasons for excluding other submissions from analysis in this thesis and provides support for this.

3.2 WHY PRIVATE INTEREST THEORY WAS SELECTED TO EVALUATE THE CURRENT REGIME?

As discussed in Chapter 2, a recurring theme identified in the key CLERP principles is the public interest. The public interest is the motivation which underpins the development of corporate law in relation to audit independence.

The public interest in the context of the auditor independence requirement explained in Chapter 2 was concerned with the economic needs of the primary users of accounting information, namely individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors.[255] However, this thesis argues that the current

[255] The definition of the public interest can be found in the now superseded Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2006) Section 100.1.1.

legislation in some circumstances does not serve the economic interests of these primary users of accounting information because it was developed to serve private interests.

Through the use of this theory, it is envisaged that the development of the current CLERP 9 legislation can be found to have (at least in some circumstances) served the private interests of certain interest groups whilst at the same time compromising ideal auditor independence. This way, potential gaps in the current legislation can be identified and legal reform can be specifically designed with the objective of promoting ideal auditor independence and therefore advancing the public interest as defined in this thesis.

The submission documents available for public inspection during the CLERP 9 and Audit Enhancement Bill public consultation processes can provide the relevant information to ascertain what the various lobby groups had lobbied for and whether any (or all) of the various groups have been successful in obtaining what they have lobbied for. For the purposes of this thesis, 'success' by a lobby group could mean either it has obtained what it has lobbied for or an outcome that is in substance[256] what it has lobbied for.

These submission documents show how lobby groups obtained legislation consistent with their own interests. We can then analyse how it falls short of the ideal independence requirement identified earlier.

According to private interest theory, certain interest groups will seek to influence the regulatory process in order to achieve an outcome that is consistent with their respective goals, which may not necessarily be in the public interest.[257] On this view, legislation (the outcome of the regulatory process) is perceived as a means (resource) by which various interest groups can enhance their respective self-interests.

Under the 'private interest' perspective of regulation, effectively organized groups can lobby successfully for their respective interests and the government can be influenced

[256] These outcomes that reflect the requests (in substance) of the various lobby groups can be observed in the composition of the memberships of the FRC and the CALDB and the cessation of the Shareholders and Investors Advisory Council, as reflected in the current regime. See Chapter 4 for an in-depth analysis of these findings.
[257] See generally, Stigler, above n 11.

by such lobbying efforts at the expense of the public interest.[258] These effectively organized groups have an advantage over the unorganized individual as these groups have access to valuable resources such as information, time and money which can be utilized to protect their own more significant financial interests.[259]

On this view, private interest theory can explain the manner in which the current regime was formulated. It is suggested that various interest groups may have an interest in protecting themselves through lobbying efforts from the consequences of Australian corporate failures like HIH and One.Tel.

The aim of this thesis is to explore whether the development of the current regime has been motivated by the self-seeking interests of the major interest groups selected to be analyzed in this thesis being the members of accounting professional bodies, managers of companies and government officials (referred to in this thesis as "**Selected Interest Groups**") rather than the public interest. This theory is best suited to be applied in this thesis as preliminary observations suggest that certain interest groups have lobbied to protect their respective interests. It is argued that the lobbying activities of these interest groups have at least in some instances influenced the CLERP 9 outcome and can therefore explain the development of the current regime. It is beyond the scope of this thesis to analyse all possible theories and to pursue the complex philosophical debates around this issue.

The interest groups analysed in this thesis were selected on the basis that these were the most obvious groups that would seek to influence the CLERP 9 auditor independence requirements. The reasons (explained in Section 3.5) can be generally summarised as members of accounting professional bodies have their livelihoods at stake, managers of companies (producer group) have to constantly ensure that audit expenses are kept under control as these costs can affect their profitability and government officials have the incentive to maintain their respective position of power or privilege within the community.

[258] Ibid.
[259] Ibid.

This thesis utilises private interest theory to identify the most direct and obvious beneficiaries of the current legislation as it is beyond the scope of this thesis to analyse all possible interest groups.

The following table summarises the Selected Interest Groups that will be examined and the respective sub-groups (where applicable) as discussed in Section 3.5.

Selected Interest Groups	***Sub-groups (where applicable)***
Members of accounting professional bodies	Accounting Associations
	Big 4 Firms
	Middle Tier Firms
	Small Firms
Managers of companies (producer group)	These comprise of producers of financial information
Government officials	Accounting Professional & Ethical Standards Board Limited
	ASIC
	ASX
	Auditing & Assurance Standards Board
	Companies Auditors & Liquidators Disciplinary Board
	Financial Reporting Council

3.3 PRIVATE INTEREST THEORY

3.3.1 An introduction to private interest theory

According to Horwitz, a theory of regulation seeks to explain the development of regulation and how key actors can influence the development of such regulation.[260] The private interest theory of regulation is applied in this thesis as certain interest groups have lobbied to protect their respective interests and have in some instances influenced the development of CLERP 9.

Originally developed by Stigler, private interest theory proposes that individuals seek to promote their respective self interests and will do so by organising themselves into lobby groups.[261] This theory proposes that the process of accommodation and compromise prior to the enactment of new legislation can be influenced by private interests.[262] As a consequence the legislative enactment may reflect the interests of the most powerful group(s).[263]

Stigler and Peltzman proposed that lobby groups that were organized effectively have an advantage over the unorganized person.[264] According to Peltzman 'these groups have access to valuable resources such as information, time and money which can be utilized to protect their own more significant financial interests'.[265] This means that effectively organized group(s) (say accountants) that have more at stake (for example their livelihoods) from the introduction of the new legislation have the potential to use these resources at their disposal to influence the outcome of the legislation for their own benefit at the expense of the unorganized person (say shareholders).

In Peltzman's view, 'the most important element of [private interest] theory is its integration of the analysis of political behaviour with the larger body of economic analysis.'[266] On this view, it is assumed that groups will form to protect their respective economic interests. In doing so, these groups will seek to lobby the government to

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[260] Horwitz, above n 9.
[261] Stigler, above n 11.
[262] Ibid and Baldwin and Cave, above n 13, 23.
[263] Stigler, above n 11.
[264] Ibid and Sam Peltzman, 'Toward a More General Theory of Regulation' (1976) 19, No. 2 *Journal of Law and Economics* 211, 240.
[265] See generally, Peltzman, above n 264.
[266] See generally, Peltzman, above n 29, 2-6.

introduce legislation that benefits their respective groups to the exclusion of others. As a consequence, the legislative outcomes reflect the interests of the most powerful group(s).[267]

According to Stigler, Peltzman, Posner and Becker, private interest theory explains how regulation can be used to serve the economic interests of politically effective groups.[268] Posner claimed that this theory is based on the assumption 'that people seek to advance their self-interest and do so rationally.'[269] As a consequence of this Stigler, Peltzman, Posner and Becker argued that groups will compete for political influence in order to have access to regulation that can enhance the welfare of these groups.[270] Horwitz was of the opinion that 'interest group bargaining takes place at the expense of the unorganized. There is no concept of the state as a positive actor. The state is little more than the vehicle for private group compromise and the source of coercion to enforce that agreement.'[271]

Stigler, Peltzman, Posner and Becker view regulation as a valuable commodity that is actively sought by powerful interest groups.[272] Once the legislative process has been captured by these interest groups, the outcome of this legislative process will be the enactment of legislation that is designed to promote the economic interests of the most powerful groups.[273] Stigler has stated that:

> The state-the machinery and power of the state-is a potential resource or threat to every industry in the society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries.[274] The state has one basic resource which in pure principle is not shared with even the mightiest of its citizens: the power to coerce. The state can seize money by the only method which is permitted by the laws of a civilized society, by taxation. The state can ordain the physical movements of resources

[267] Ibid 6-7.
[268] See generally, Stigler, above n 11, Peltzman, above n 264, Posner, above n 29 and Becker, above n 29.
[269] Posner, above n 29.
[270] Stigler, above n 11, Peltzman, above n 264, Posner, above n 29 and Becker, above n 29.
[271] Horwitz, above n 9.
[272] Stigler, above n 11, 5, Horwitz, above n 9, 36, Peltzman, above n 264, Posner, above n 29 and Becker, above n 29.
[273] Stigler, above n 11, 5, Horwitz, above n 9, 36, Peltzman, above n 264, Posner, above n 29 and Becker, above n 29.
[274] Stigler, above n 11, 3.

> and the economic decisions of households and firms without their consent. These powers provide the possibilities for the utilization of the state by an industry to increase its profitability.[275]

According to Stigler, Peltzman, Posner and Becker, legislation is enacted to serve the interests of various groups including politicians who seek re-election.[276] They were of the view that votes and money are critical resources that can determine the success or failure of a political campaign. That is self-interested politicians would be willing to lend their support to vote in favour of enacting legislation that would benefit the economic interests of powerful groups potentially at the expense of the public interest in exchange for these resources. [277] As a result, groups that are able to organise effectively to deliver these resources to self-interested politicians stand to benefit from the political process as compared to the unorganised person who does not have the means on his or her own to provide such resources on a large scale.[278]

Stigler stated:

> The industry which seeks political power must go to the appropriate seller, the political party. The political party has costs of operation, costs of maintaining an organization and competing in elections. These costs of the political process are viewed excessively narrowly in the literature on the financing of elections: elections are to the political process what merchandizing is to the process of producing a commodity, only an essential final step. The party maintains its organization and electoral appeal by the performance of costly services to the voter at all times, not just before elections.[279]

Peltzman agreed with Stigler as follows:

> As the politician's ultimate goal is securing and enhancing his / her power, the politician prefers decisions that directly elicit favourable votes. Regulatory

[275] Ibid 4.
[276] Stigler, above n 11, 12, Peltzman, above n 264, Posner, above n 29 and Becker, above n 29.
[277] Stigler, above n 11, 12, Peltzman, above n 29, Posner, above n 29 and Becker, above n 29.
[278] Stigler, above n 11, 12, Peltzman, above n 29, 7-8, Mitnick, *The Political Economy of Regulation – Creating, Designing, and Removing Regulatory Forms* (Columbia University Press, 1st ed, 1980) 114, Posner, above n 29 and Becker, above n 29.
[279] Horwitz, above n 9, 12.

> decisions can also elicit campaign contributions, contributions of time to get-out-the vote, occasional bribes, or well-paid jobs in the political afterlife. As the more well-financed and well-staffed campaigns tend to be the more successful and because a self-interested politician also values wealth, he / she will pay attention to these resource (money) consequences of regulatory decision as well as to the direct electoral consequences.[280]

The existence of politically effective interest groups has caused regulation to be described as a commodity subject to the laws of economics of supply and demand. According to Posner:

> Since the coercive power of government can be used to give valuable benefits to particular individuals or groups, economic regulation-the expression of that power in the economic sphere-can be viewed as a product whose allocation is governed by laws of supply and demand[281] … There are a fair number of case studies-of trucking, airlines, railroads, and many other industries-that support the view that economic regulation is better explained as a product supplied to interest groups than as an expression of the social interest in efficiency or justice.[282]

Becker further developed Stigler's theory and claimed that 'individuals belong to particular groups-defined by occupation, industry, income, geography, age, and other characteristics-that are assumed to use political influence to enhance the well-being of their members.'[283] Becker declared that groups with such characteristics can be considered 'active groups [that] produce pressure to raise their political influence and the sum of all influences are jointly determined by the pressures produced by all groups.'[284] Becker's view that 'governments can correct market failures by favouring the politically powerful' is consistent with that of Stigler, Peltzman and Posner.[285]

According to Becker while a politically active group with similar characteristics may be willing to incur costs to become well informed about political issues in order to protect their common economic interests, the unorganised individual will be less

[280] Peltzman, above n 29, 6-7.
[281] Posner, above n 29, 344.
[282] Ibid 350.
[283] Becker, above n 29, 372.
[284] Ibid 394-5.
[285] Ibid 396, Stigler, above n 11, Peltzman, above n 264 and Posner, above n 29.

motivated to do so.[286] Becker maintained that there is greater motivation for an individual to become well informed about most private decisions (for example, a decision to purchase a car). This is because such private decisions have a direct impact on their general well-being be it financial or otherwise and as a result the individual will have to live with the consequences of his/her mistake. On the other hand there is less incentive to become well informed about political issues as each individual knows that he/she by him/herself will not be able to have significant influence on the political outcome to be decided by the majority.[287]

As explained above, private interest theory is applicable when powerful interest groups are able to successfully lobby for their respective self-interests. This theory however assumes that the government can be influenced by the lobbying efforts of these powerful interest groups. Li and Xu have suggested that this can only happen when a government is willing to listen to its constituents.[288] They have stated that the ability of various groups to effectively lobby for their respective interests is dependent on the extent of democracy that exists in the respective jurisdiction. In their view, 'a more democratic society provides more effective channels for its constituents to voice concerns and erects lower barriers for its constituents to organize interest groups.'[289] As a result the greater the extent of democracy practiced in the respective jurisdiction, the higher the likelihood of private interest theory being applicable. Applying Li and Xu's view, private interest theory may not be applicable in an environment where democracy is non-existent, for example, in a dictatorial regime as compared to a fully matured democracy such as that which is practiced in Australia.

In sum, private interest theory is applied in this thesis to examine the development of the auditor independence requirements in CLERP 9 due to the existence of certain interest groups that would be keen to influence the development of the regulatory process for their own benefit. These interest groups will comprise of likeminded individuals with similar characteristics and as a consequence have common goals. The ability of these

[286] Becker, above n 29, 392.
[287] Ibid.
[288] Wei Li and Colin Xu, 'The Political Economy of Privatization and Competition: Cross-Country Evidence from the Telecommunications Sector' (April, 2002) 30 *Journal of Comparative Economics* 439, 443-444.
[289] Ibid.

groups to lobby effectively for their self-motivated interests can be constrained by the extent to which the government is willing to seek the views of its constituents on such regulatory proposals and the available resources (time and money) at their disposal to lobby for their respective interests.

As suggested above, the more resources (time and money) an interest group has at its disposal, the higher the likelihood of it being able to influence the regulatory process. This is because political lobbying involves costs that may be prohibitive to interest groups that do not have sufficient resources. The next section explains what these prohibitive costs are.

3.3.2 The prohibitive costs that can influence the regulatory outcome

Peltzman has provided some insight as to what these prohibitive costs entail. Peltzman has identified two types of costs that play a part in an interest group's ability to influence the regulatory process. These are information and organization costs.[290]

Information costs are the costs that will be borne by the individual in order for the individual to be adequately informed about a regulatory proposal. Such information would include details as to how the regulatory proposal will affect the individual's economic interests. This way, the individual would be in a position to make a well-informed and timely decision in relation to the regulatory proposal.[291]

Organization costs pertain to the costs involved for the individual to seek out other likeminded individuals and to set up an effective lobby group that can lobby for, against or abstain from lobbying on the regulatory proposal so as to promote their financial interests.[292]

It is unlikely that an individual would want to incur such costs as there is no direct benefit to be gained from such an exercise. As suggested by Becker, there is less incentive for the individual to incur such costs as each individual knows that he/she by

[290] Peltzman, above n 264, 213.
[291] Ibid.
[292] Ibid.

him/herself will not be able to have significant influence on the outcome of the regulatory proposal to be decided by the majority.[293]

On the other hand, Becker declared that individuals that belong to particular groups (such as by occupation and industry) have more money at their disposal as a result of their combined resources. These groups are in a better position (as compared to the unorganised individual) to obtain timely and relevant information in relation to the regulatory proposals as to what is at stake and how these proposals can affect their respective financial interests. These groups have the ability to rapidly organize themselves to lobby effectively for, against or abstain from lobbying on the various regulatory proposals in order to protect their respective financial interests.[294]

3.3.3 The moderated final outcome

According to private interest theory, the motivations behind the lobbying activities of these interest groups were driven by self-seeking interests. As a consequence, it is unlikely that the current auditor independence legislation (in its entirety) can be said to be consistent with ideal independence. Likewise, it would be incorrect to assume that the development of the current auditor independence legislation was driven purely by rational economic principles.

The idea that is being mooted by the advocates of private interest theory (such as Stigler, Peltzman, Posner and Becker) is that groups that do not have significant financial wealth at their disposal to organise themselves into lobby groups with likeminded interests, will not be able to lobby effectively for regulation that may protect their respective interests. On this view legislation can in some circumstances be enacted to promote the economic interests of those who are in a position of power and influence at the expense of others who do not have significant financial wealth.

Hirshleifer argued that it is generally in the political interest of the regulators to moderate the final outcome so as to ensure that the economic benefit/loss arising from the regulatory process is distributed widely across all groups including the large, diffused group comprised of unorganized individuals. In doing so, the regulators would ‘lean

[293] Becker, above n 29, 392.
[294] Ibid 375.

against the wind' so that the regulatory outcome will only reflect the majority (and not all) of the proposals put forward by the powerful interest groups.[295] This way the economic interests of the other groups can also be promoted (albeit to a lesser extent).[296]

This thesis adopts the private interest theory perspective suggested by commentators such as Stigler, Peltzman, Posner and Becker that groups will lobby to protect their respective interests as well as the views of Hirshleifer that further builds upon this theory by stating that the end product of this regulatory process is not only the outcome of intense lobbying among various interest groups but also a moderated final outcome in order for the appearance of social gain to be distributed.

On this view it is argued that the development of the current auditor independence legislation has been influenced by the lobbying activities of various powerful interest groups and the Australian government's efforts to accommodate and appease these interest groups. In doing so, the Australian government may unintentionally compromise ideal independence in some instances in order to accommodate the interests of various interest groups. The Australian government however will not select one single group for preferential treatment. This way it will not be seen to be favouring one particular group at the expense of others. Rather it can be perceived by the general public to be considering a wide range of interests from its constituency.

In order to ensure that some portion of the benefit resulting from new legislation is distributed to all interest groups, the government may have in some instances, provided alternative solutions that appear to enhance ideal auditor independence. Such measures may result in a less than ideal version of auditor independence. In these circumstances, ideal auditor independence could be compromised. These solutions cannot and should not be considered as ideal solutions. As such, it can be argued that the moderated final outcome achieved by the government, as a result of the introduction of some of the various proposals successfully lobbied by these respective interest groups, may not necessarily be in the best interests of the public and may even be at the expense of the public.

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[295] Jack Hirshleifer, 'Toward a More General Theory of Regulation: Comment' (August, 1976) 19, No. 2 *Conference on the Economics of Politics and Regulation* 241, 243.
[296] Ibid.

This moderated final outcome if found to exist in the current auditor independence legislation suggests that some interest groups stand to benefit more by the introduction of the various auditor independence proposals successfully lobbied by them. If this can be established in this thesis, this would mean that the Australian government's efforts to accommodate and appease the wide range of interests from its constituency (including certain interest groups) may have unintentionally resulted in ideal independence being compromised.

3.3.4 How private interest theory will be applied in this thesis

This theory which has been applied in countries such as the United States,[297] is similarly applied to the auditor independence requirements in Australia for the purposes of this thesis. Various aspects of this theory have been adopted for the purposes of analysing the development of CLERP 9 whilst other elements have been intentionally excluded as explained in the following paragraphs.

A political party needs to obtain as many votes as possible in order to form government and therefore they seek to win support by being perceived as being proactive following a corporate collapse such as HIH. Evidence (or lack) of such support of the government's handling of the matter can be observed through voting power. Improving auditor independence is one way the government can be seen to be proactive in the wake of the HIH collapse. The current regime which endeavours to improve auditor independence is the outcome of such a process to win voter support.

As shown previously, self-interested politicians can be 'bought' with money and votes.[298] Lobby groups that are able to deliver these resources to these politicians can therefore influence the outcome of the regulatory process in order to benefit their respective economic interests at the expense of the public interest.[299] In the context of the audit independence requirements in Australia, the regulatory process is not 'bought' with money and votes. This thesis argues that private interest theory is still applicable because

[297] Stigler, above n 11, 12 and Peltzman, above n 29, 6-7.
[298] Stigler, above n 11, 12 and Peltzman, above n 29, 6-7.
[299] See discussion in Section 3.3.1, Stigler, above n 11, 12 and Peltzman, above n 29, 6-7.

the Australian government will seek to accommodate a wide range of interests from its constituents that will inevitably include powerful interest groups. This form of accommodation by the Australian government with certain influential interest groups can potentially lead to the enactment of audit independence legislation that falls short of the ideal independence standard.

Whether various interest groups have 'bought' the government by providing financial or other support as suggested by (amongst others) Stigler, Posner and Peltzman is not within the scope of this thesis. As such, this thesis will not seek to investigate whether regulatory decisions can directly elicit votes, money, favours and/or other questionable contributions. Instead, this thesis will focus on whether effectively organized groups have lobbied successfully for their respective interests and whether the government has been influenced by such lobbying efforts at the expense of greater auditor independence (the public interest). Effectively organized groups have an advantage over the unorganized individual as these groups have access to valuable resources such as information, time and money which can be utilized to protect their own more significant financial interests.

3.4 PRIVATE INTEREST THEORY IN THE CONTEXT OF ACCOUNTING REGULATION

The previous part of this chapter introduced private interest theory and discussed how the application of this theory can explain the development of regulation generally. This section provides various examples of how this theory has been adopted to explain the development of the accounting standard setting process.

Private interest theory has been adopted in the various examples discussed below to explain how the regulatory process has developed as it takes into consideration the special interest that various interest groups have in influencing the regulatory outcome. This is consistent with the views of Stigler, Posner and Becker, that political systems have been subject to pressures from special interest groups that try to use influence to enhance their welfare.

Different interest groups have various reasons for promoting their respective self-interests. Depending on what is at stake, the interest groups that will be affected by the

outcome of the regulatory process may vary and so will the respective motivation(s) for these interest groups to influence the regulatory process. The findings from this analysis will be used to explain why the Selected Interest Groups were determined for the purposes of analysing the development of CLERP 9.

Deegan, Morris and Stokes maintained that 'audit firms are relatively more likely to lobby in favour of particular accounting methods if those methods are already in use by a number of their clients.'[300] The application of private interest theory in these circumstances would mean that these audit firms were lobbying to protect their interests. The reason for this could be that audit firms favour rules that reduce the amount of time taken required to conduct an audit. As these 'methods are already in use by a number of their clients' familiarity with the 'particular accounting methods' would enable the audit firm to complete the audit in a shorter amount of time as compared to the application of new and unfamiliar methods. In addition the risk that the auditor could be found to be negligent during the conduct of the audit is reduced as the audit firm would be well versed with the application of the existing methods.

Puro however claims that the opposite could also happen in that audit firms can favour the application of new methods if the audit firms are adequately renumerated for their additional work.[301] Puro conducted a study on the lobbying activities of audit firms in the United States[302] in relation to the accounting standard setting process. Puro suggests that audit firms will favour the application of new disclosure rules because audit firms can expect to generate additional audit fees as a result.[303] Puro further adds that if small audit firms lack the specialization to generate the additional business, large audit firms would be more likely to support the new disclosure rules.[304]

According to Walker and Robinson, the threat by the Australian Stock Exchange (now known as the Australian Securities Exchange) to intervene in the accounting standard setting process was sufficient incentive for the accounting profession to abandon

[300] Craig Deegan, Richard Morris and Donald Stokes, 'Audit Firm Lobbying on Proposed Disclosure Requirements' (1990) 15(2) *Australian Journal of Management* 261, 266.
[301] Marsha Puro, 'Audit Firm Lobbying Before the Financial Accounting Standards Board: An Empirical Study' (Autumn, 1984) 22(2) *Journal of Accounting Research* 624, 624.
[302] Ibid.
[303] Ibid 627.
[304] Ibid 627-8.

their lobbying efforts to impede the development of a particular accounting standard.[305] These commentators stated that the Australian Accounting Research Foundation ("**AARF**") (sponsored by the accounting profession) had lobbied for the disclosure of funds statements instead of the statement of cash flows. They claimed that the AARF attempted to delay the Accounting Standards Review Board (now known as the Australian Accounting Standards Board) from developing an accounting standard in relation to the statements of cash flows.[306] Walker and Robinson noted that the Australian Stock Exchange subsequently gave notice in 1990 of its intention to require listed companies pursuant to the listing requirements to provide a statement of cash flows by 1992. They stated that the Australian Stock Exchange threatened to introduce its own requirements if the Accounting Standards Review Board failed to issue an accounting standard for that purpose. According to Walker and Robinson, this threat was sufficient to cause the accounting profession to work with the Accounting Standards Review Board to develop and issue an accounting standard in relation to the statements of cash flows in December 1991.[307]

Brown and Tarca have noted that the professional accounting bodies have the ability to wield significant influence in order to promote their respective interests during the accounting standard setting process.[308] They examined a separate CLERP 9 proposal that is not directly associated with improving auditor independence and as a consequence has been intentionally excluded from analysis in this thesis. They analysed how lobbying by various interest groups (including the professional accounting bodies) had successfully lobbied against a CLERP 9 proposal to replace the existing Australian accounting standards ("**ASA**") with International Accounting Standards ("**IAS**").[309] In their view, by delaying the 'wholesale adoption' of the IAS, the professional accounting bodies were able to maintain their influence over the Australian accounting standards process as compared to the delegation of this authority to an international body being the International Accounting Standards Committee ("**IASC**") where their influence will be

[305] Robert Walker and Peter Robinson, 'Competing Regulatory Agencies with Conflicting Agendas: Setting Standards for Cash Flow Reporting in Australia' (1994) 30(2) *ABACUS* 119, 131.
[306] Ibid.
[307] Ibid.
[308] Brown and Tarca, above n 15, 296.
[309] Ibid 281.

greatly reduced.[310] They concluded that the threat to this influence can take the form of for example, the reduced likelihood of the professional accounting bodies' representation on the governance of the IASC and as a consequence their ability to influence the international standards as compared to their existing leadership role in lobbying for Australian standards.[311] In addition to Brown and Tarca, Godfrey has also proposed that private interest theory can be used to explain why the Australian professional accounting bodies (Institute, CPA and the IPA) may want to influence the accounting standard setting process.[312] Brown and Tarca also alluded to the existence of other interest groups (other than the professional accounting bodies) that also sought to influence the standard setting process. These interest groups included the producers of financial information (companies) as well as the regulators (for example, ASIC and the ASX).[313] In doing so, they suggested that the lobbying by producers of financial information and the regulators would be motivated by cost savings and outcomes that would make economic sense.[314] They noted however that ASIC (then known as the Australian Securities Commission) did not take an active role in the process. They concluded that this was probably attributed to ASIC's emphasis on monitoring and compliance rather than standard setting.[315]

The findings by commentators such as Deegan, Morris and Stokes, Puro, Walker and Robinson and Brown and Tarca in the selection of the various interest groups as set out in the above examples are similarly applied in the identification of the relevant interest groups to be examined in this thesis. The next section explains this.

3.5 UTILISING PRIVATE INTEREST THEORY TO IDENTIFY THE SELECTED INTEREST GROUPS FOR THE PURPOSES OF EVALUATING CLERP 9

Private interest theory proposes that in the background, there are powerful user groups that will seek to influence the regulatory process for their own benefit which may not necessarily be in the public interest. Section 3.4 explained how the various interest

[310] Ibid 282.
[311] Ibid 292.
[312] See generally, Jayne Godfrey et al, *Accounting Theory* (John Wiley & Sons Australia, 6th ed, 2006).
[313] Brown and Tarca, above n 15, 270.
[314] Ibid 278.
[315] Ibid 279.

groups were identified by reference to what they stand to gain (or lose as the case may be) by the outcome of the regulatory process and their respective motivations to influence the regulatory process. This section similarly explains how the Selected Interest Groups[316] were determined by applying private interest theory. This method is based on identifying what the interest groups have at stake as a consequence of the regulatory process and their self-interested incentives to influence the regulatory process.[317]

The Selected Interest Groups have an incentive to influence the legislature so as to benefit from the introduction of the new legislation. The Selected Interest Groups were determined after careful evaluation as the groups that will most likely value the outcome of any company law reform in relation to auditor independence. The members of accounting professional bodies have their livelihoods at stake, managers of companies (producer group) have to constantly ensure that audit expenses are kept under control as these costs can affect their profitability and government officials have the incentive to maintain their respective position of power or privilege within the community.

This means that the legislature can be influenced by the Selected Interest Groups since the Selected Interest Groups stand to lose or gain from the introduction of such legislation. Put simply, compact, organized groups would stand a better chance of lobbying successfully for their respective interests at the expense of a diffused group of unorganised individuals.

This section discusses why the Selected Interest Groups were used to evaluate the current regime under the sub-headings - Members of accounting professional bodies, Managers of companies (producer group) and Government officials.

3.5.1 Members of accounting professional bodies

This thesis concurs with Brown, Tarca[318] and Godfrey's[319] comments that the professional accounting bodies have the capability to influence the accounting standard setting process. This thesis argues that the professional accounting bodies (Institute, CPA

[316] The Selected Interest Groups were previously identified in the table in Section 3.2.
[317] The reasons for excluding certain parties from being analysed in this thesis are explained in Section 3.6.
[318] Brown and Tarca, above n 15, 296.
[319] See generally, Godfrey et al, above n 312.

and the IPA) will seek to promote their respective interests in relation to auditor independence legal reform.

In analysing the lobbying decisions of audit firms to lobby in favour of existing and familiar accounting methods as described above, Deegan, Morris and Stokes have stressed the importance of the anticipated cost savings to audit firms and the perceived reduction of auditor liability as a result.[320] Likewise, in investigating the lobbying efforts of audit firms in relation to the application of new disclosure rules, Puro emphasised the importance of increased audit revenue that audit firms can expect to receive as a consequence of the new disclosure requirements.[321]

The motivations that influence the decisions of members of accounting professional bodies to lobby during the accounting standard setting process such as cost savings as suggested by Deegan, Morris and Stokes[322] and increasing audit revenue as proposed by Puro[323] can be similarly applied in the context of auditor independence legal reform. Their views are adopted in this thesis as it is suggested below that auditors will seek to lobby against proposals that may increase audit costs and proposals which may lead to a decrease in profits for audit firms.

This thesis proposes that the members of the Australian accounting professional bodies have had an influence in the development of the current regime. Factors that may influence their decision to lobby for or against legal reform in relation to auditor independence includes (amongst other things) potential loss of recurring fees from audit and/or non-audit clients, increase in audit costs as a result of more stringent legislation for auditors (for example, compulsory auditor rotations for listed entities) which may lead to a decrease in profits for audit firms and legal reform aimed at curbing or reducing their influence in the audit standard setting process.

These members of the Australian accounting professional bodies have been further subdivided into smaller groups. These groups consist of the Accounting Associations, Big 4 Firms, Middle Tier Firms and Small Firms. The Accounting Associations are

[320] Deegan, Morris and Stokes, above n 300.
[321] Puro, above n 301, 627.
[322] Deegan, Morris and Stokes, above n 300.
[323] Puro, above n 301, 627.

grouped together because these associations have provided (amongst other submissions) joint submissions, collectively representing all 3 associations. These associations also have common interests. One such common interest is to increase or at the very least, to maintain their respective influence in the audit standard setting process. Failure to maintain this influence can lead to their eventual lack of relevance and subsequent demise. In relation to the Big 4 Firms, Middle Tier Firms and Small Firms categories, these accounting firms have been grouped together accordingly based on the way they have described themselves in their respective submissions. The Big 4 Firms, Middle Tier Firms and Small Firms are also grouped on the basis of common interests shared by the respective groups. For example, the size of the audit firm has a direct bearing on the type of audit client the firm can provide audit services to. Larger firms generally have more audit staff and audit expertise in terms of specialisations available. As a consequence the audit clients of larger firms would include listed entities which require such resources and expertise. On the other hand, the client base of smaller audit firms generally comprise of non-listed entities which by virtue of their size and nature of business, do not require as many audit staff and specialised audit experience to complete the audit. Medium sized firms may have a mix of listed and non-listed entities as audit clients. In most instances however the majority (if not all of their clients) would comprise of non-listed entities. The various audit firms discussed in this thesis can therefore be categorized into three broad categories being Big 4 Firms, Middle Tier Firms and Small Firms on the basis of their common interests (for example by type of audit clients). They are grouped together as such, as each category of audit firm will seek to protect their respective economic interests which can vary significantly from one group to another.

3.5.2 Managers of companies (producer group)

Feroz and Hagerman have commented on Puro's findings and have stated that audit firms are not the direct beneficiaries of new disclosure rules.[324] They state that audit firms are not the issuers of financial statements. The issuers of financial statements are the companies which the audit firms audit. As a consequence the interests of the direct

[324] Feroz Ehsan and Robert Hagerman, Does the Stiglerian Theory of Regulation Explain The Audit Firm Lobbying Before the FASB? (2008) http://ssrn.com/abstract=1230383 at 4 January 2010.

beneficiaries (audited companies) need to be examined.[325] This is also the case in Australia. This thesis agrees with Feroz and Hagerman's assertions that as the issuers of financial statements stand to directly benefit from any auditor independence legal reform, the managers of companies (producer group), as an interest group needs to be evaluated.

Shea and Chari have commented on the influential role that the managers of companies (producer group) have played in the development of merger control regulation ("**MCR**") in the European Union. They analysed how the Nestle/Perrier merger in 1992 influenced the development of the MCR. Shea and Chari's findings from the Nestle/Perrier merger indicate that the managers of companies (producer group) such as Nestle and BSN would seek to lobby for regulation that could increase their respective profits.[326] Nestle and BSN, both being business entities, had profitability in mind and as a consequence were motivated to use this opportunity to increase their respective market share by taking advantage of the new markets offered by the newly formed European Union.[327]

Although this example analysed the development of competition regulation in the European Union, this thesis argues that the managers of companies (producer group) may also seek to influence the development of auditor independence legal reform Australia in order to protect and/or increase their respective profits. This is consistent with Brown and Tarca's comments in that the managers of companies (producer group) have an incentive to lobby for economic outcomes that can potentially provide financial benefits to each of them respectively.[328]

This thesis proposes that there exists a special interest group consisting of various Australian entities that may have lobbied for the current regime. Managers of Companies (Producer Group) are defined as producers of financial information. As such this category comprises of Australian entities that produce financial information. Factors that may influence their decision to lobby for or against legal reform in relation to auditor independence includes (amongst other things) increase in audit costs as a result of more

[325] Ibid.
[326] Eric Shea and Raj Chari, 'Policy Formulation, Implementation and Feedback in EU Merger Control' (Working Paper prepared for the Institute for International Integration Studies, 2005) 17.
[327] Ibid 17-18.
[328] Brown and Tarca, above n 15, 278.

stringent legislation for auditors (for example, compulsory auditor rotations for listed entities), legal reform aimed at curbing or reducing their influence in the audit standard setting process and the creation of additional obligations on entities to disclose more information.

3.5.3 Government officials

The Nestle/Perrier merger not only provides an example of the lobbying behaviour of managers of companies (in this instance, multi-national conglomerates) but it also provides supporting evidence of how the regulator (the MTF) can also be an interest group – a group that is motivated to use this Nestle/Perrier test case to cement its role and extend its influence in the European Union.[329]

The commentary by Shea and Chari suggested that the newly created European Union offered the opportunity for various actors to compete for political influence in previously unchartered political territory. The MTF was put forward as one such actor as it was motivated to establish its role as the regulatory body that could decide on matters concerning merger control regulation in the European Union.[330] It can therefore be said that the self-seeking interest of the MTF was to establish its influence in the development of merger control regulation thereby ensuring its position of power and privilege in this aspect within the European Union community.

In addition to Shea and Chari, Brown and Tarca have also acknowledged the existence of the regulator(s) as another interest group(s) that may seek to influence the development of the regulatory process.[331] Brown and Tarca have suggested that the regulators (such as the APESB, AASB, CALDB, FRC, ASIC and the ASX) can be considered as separate and distinct interest groups as these entities may have an incentive to lobby for their respective interests.[332]

This thesis concurs with Brown and Tarca in that the APESB, AASB, CALDB, FRC, ASIC and the ASX can be categorized as distinct and separate special interest groups to be evaluated. This is because these entities function independently from the

[329] Shea and Chari, above n 326.
[330] Ibid.
[331] Brown and Tarca, above n 15, 270.
[332] Ibid.

other and have separate and distinct roles to perform in relation to the audit independence regulatory function. Despite these differences, these entities can have the same and/or similar motivations for pursuing their respective self-interests as discussed below.

The Accounting Professional & Ethical Standards Board Limited is funded by the Accounting Associations but represents to be 'an independent, national body that sets the code of ethics and professional standards' for the members of the Accounting Associations to comply.[333] The Accounting Professional & Ethical Standards Board Limited is considered a regulator for the purposes of this thesis, as it can potentially influence the development of auditor independence standards that can affect the manner in which members of the Accounting Associations conduct the external audit for their clients. As the Accounting Professional & Ethical Standards Board Limited has been entrusted with the responsibility of standard setting as it relates to professional conduct and ethics for the Accounting Associations, it has a special interest in ensuring that this measure of influence is sustained and/or increased well into the future in order to maintain its position of power and privilege in this standard setting process. The APESB has shown its intent to lobby for its interests as it has furnished a submission to the Treasury in relation to the Audit Enhancement Bill.[334]

The Auditing & Assurance Standards Board 'is an independent, statutory agency of the Australian government, responsible for developing, issuing and maintaining auditing and assurance standards'.[335] Its mission 'is to develop, in the public interest, high-quality auditing and assurance standards' that are legally enforceable under the Corporations Act in order to enhance the credibility of audited financial information.[336] As in the case of the Accounting Professional & Ethical Standards Board Limited, the Auditing & Assurance Standards Board is considered a regulator due to its ability to influence the auditor independence regime through its capacity to develop related standards that can regulate the conduct of the external audit by members of the Accounting Associations.

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[333] Accounting Professional & Ethical Standards Board Limited, *About us* <http://www.apesb.org.au/apesb-content/47/about-us>.
[334] Accounting Professional & Ethical Standards Board Limited, Submission to the Treasury, *Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth)*, 28 October 2011, 3.
[335] Auditing & Assurance Standards Board, *About the AUASB* <http://www.auasb.gov.au/About-the-AUASB.aspx>.
[336] Ibid.

Likewise, the Auditing & Assurance Standards Board has been similarly entrusted with the responsibility of standard setting as it relates to auditing and in particular audit independence for the Accounting Associations, it also has a special interest in ensuring that this measure of influence is sustained and/or increased well into the future in order to maintain its position of power and privilege in this standard setting process. A submission was noted to have been prepared by the AASB and presented to the PJCCFS concerning the Relevant Proposals.[337] This provides support that it is keen to lobby for its interests.

The CALDB is a disciplinary body that conducts hearings in response to applications made by ASIC[338] to determine whether a registered auditor has contravened the Corporations Act by (amongst other things) failing to adhere to their respective codes of professional conduct in relation to auditor independence.[339] In addition, the CALDB also conducts hearings to determine the administrative and conduct matters of registered liquidators.[340] The CALDB has a public protective role by virtue of its powers to cancel or suspend an auditor's registration.[341] The CALDB is therefore considered a regulator for the purposes of this thesis due to its public protective role and its ability to reprimand registered auditors for non-compliance of the auditor independence requirements in relation to their respective codes. The CALDB will have a keen interest in preserving and enhancing its public protective role in order to maintain its position of power or privilege within the community and as a consequence will be motivated to influence the development of the current regime to achieve that outcome. The CALDB has indicated that it is interested to lobby for its interests as it has procured a submission to the Treasury in relation to the Relevant Proposals.[342]

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[337] Auditing & Assurance Standards Board, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 28 November 2003, 5.
[338] Corporations Act s 1292(1).
[339] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters* (January 2011) 3 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters* (June 2012) 3.
[340] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters* (January 2011) 3 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters* (June 2012) 3.
[341] Companies Auditors and Liquidators Disciplinary Board, *Annual Report for the year ended 30 June 2012* (2012) 2.
[342] Companies Auditors & Liquidators Disciplinary Board, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 21 November 2002, 1-2.

The FRC is entrusted with the responsibility for providing broad oversight of the process for setting accounting and auditing standards as well as the delivery of strategic policy advice and reports to the Treasurer and professional accounting bodies in relation to the quality of the external audit.[343] The strategic policy advice offered by the FRC can include matters in relation to the auditor independence requirements in the Corporations Act, the auditing standards and the codes of professional conduct adhered to by members of the Accounting Associations.[344] The FRC can be considered a regulator as it has the potential to influence the development of auditing standards through its broad oversight function and the provision of strategic policy advice in relation to auditing and in particular audit independence. The FRC will be motivated to seek to influence the development of the current regime. By cementing its role as a key actor in the regulatory process, it can maintain its position of power or privilege within the community. The FRC was noted to have submitted submissions on two separate occasions, once in relation to the Relevant Proposals and the other in relation to the Audit Enhancement Bill.[345] This indicates that the FRC is motivated to lobby for its respective interests.

ASIC is the regulator primarily responsible for monitoring and enforcing the auditor independence requirements in Australia pursuant to the Corporations Act.[346] ASIC's audit oversight activities can promote ideal auditor independence as the threat of enforcement action by ASIC can act as a deterrent to potentially non-complying auditors to conform with the current requirements. ASIC must be seen to be proactive or else it risks facing public outcry and scrutiny which can eventually lead to its lack of relevance and subsequent demise.

Brown and Tarca noted that the ASIC did not actively take part in the lobbying process (in relation to the CLERP 9 proposal to replace the existing Australian accounting standards with the 'wholesale adoption' of the International Accounting

[343] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[344] Ibid.
[345] Financial Reporting Council, Submission to the Treasury, *Exposure Draft Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 10 November 2003, 1 and Financial Reporting Council Audit Quality Task Force, Submission to the Treasury, *Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth)*, (undated), 1.
[346] See generally, ASIC Act Part 3 Division 3 and Corporations Act Part 2M Division 3.

Standards) and suggested that the reason for this could be due to ASIC's emphasis on monitoring and compliance rather than standard setting.[347] This thesis disagrees with their view and argues that ASIC has an incentive to take an active role in the regulatory process in relation to the audit independence requirements in CLERP 9 because ASIC's role pursuant to the Corporations Act stipulates that it takes a proactive role in monitoring and enforcing contraventions of the audit independence requirements.[348] In order to fulfil this proactive role, ASIC would be keen to influence the development of audit independence regulation as the outcome of such a process will inevitably have an impact on its monitoring and enforcement function. Lax regulation (for audit independence compliance) can result in many potential breaches being undetected by ASIC, whereas overly-stringent regulation can stretch ASIC's resources beyond its effective enforcement capability. Failure to fulfil this role can lead to public outcry and scrutiny which can result in its subsequent demise and loss of influence in the regulatory process. The contention that ASIC is keen to lobby for its interests, is supported by the fact that ASIC has provided a submission to the Treasury in relation to the Relevant Proposals.[349]

The ASX has assumed a leadership role in enhancing Australian corporate governance practices.[350] The entities trading on the ASX represent some of the largest companies by market capitalisation in Australia.[351] The regulatory influence that the ASX wields on these listed entities is by no means insignificant. The threat of government intervention in circumstances where the ASX has been found to show a lack of leadership in its role in enhancing Australian corporate governance practices (for example, in the area of auditor independence) can lead to the erosion of such regulatory influence. As in the case of the APESB, AASB, CALDB, FRC and ASIC, the ASX has shown that it is also eager to lobby for its interests as it has also presented submissions on two separate occasions in relation to the Relevant Proposals.[352]

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[347] Brown and Tarca, above n 15, 279.
[348] See generally, ASIC Act Part 3 Division 3 and Corporations Act Part 2M Division 3.
[349] ASIC, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, November 2002, 5.
[350] ASX, *Corporate Governance Council* <http://www.asx.com.au/regulation/corporate-governance-council.htm>.
[351] ASX, *Listing on ASX* <http://www.asx.com.au/listings/listing-on-ASX.htm>.
[352] ASX, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 22 November 2002, 1 and ASX, Submission to the PJCCFS, *Corporate*

Brown and Tarca also noted that the ASX being a listed entity itself, can also be considered a producer of financial information and therefore can also be included in the interest group - the Managers of Companies (Producer Group) in addition to being a regulator.[353] This thesis acknowledges that while the ASX can also be motivated by the same economic outcomes as other listed entities, the ASX's leadership role in enhancing corporate governance practices and the public perception that it continues to do so suggests that its regulatory role takes precedence over any prospect of profiting by dishonest means when there is a conflict of interest. On this view it is analysed in this thesis from the perspective of a regulator.

The APESB, AASB, CALDB, FRC, ASIC and the ASX will be motivated to influence the development of the current regime in order to ensure the maintenance of its respective position of power or privilege within the community. Other factors that may influence their decision to lobby for or against legal reform in relation to auditor independence includes (amongst other things) legal reform aimed at curbing or reducing their influence in the audit standard setting process, the creation of additional obligations on the regulator that may increase the risk of legal proceedings being commenced against the regulator by aggrieved persons and any other action which may cause the regulator to have a reduced position of power or privilege within the community.

3.6 CRITERIA FOR EXCLUDING OTHER SUBMISSIONS

Within the scope of this thesis it has not been possible to examine the influence of every submission made in response to the Relevant Proposals. Hence, some submissions have been ignored. The reasoning behind these exclusions is outlined below. Traditional literature using private interest theory[354] in the context of corporate and accounting legislation have broadly focused on the lobbying efforts of groups such as the Selected Interest Groups for the purposes of analysing how a particular regulatory process may have been influenced by self-seeking interests. Private interest theory has generally based

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Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth), 10 November 2003, 3.

[353] Brown and Tarca, above n 15, 277.

[354] Stigler, above n 11, 12, Peltzman, above n 29, Posner, above n 29 and Becker, above n 29.

this approach on the assumption that these groups stand to gain/lose the most from any change to the particular regulatory outcome being examined and as a consequence have the most incentive to lobby for their respective interests.[355] In adopting this approach, the literature ignored some parties who may also have made submissions in the legislative process. This thesis similarly applies the same approach in not considering in detail the submissions from these types of groups.

This perspective of private interest theory does not take into account the possibility that in the specific area covered in this thesis that there could be an interest group(s) that may be keen to lobby for the public interest (for example, ideal auditor independence) for less direct economic and/or reputational reasons. Private interest theory assumes that powerful interest groups will seek to influence the legislative outcome for reasons that can be generally perceived to be directly attributed and/or closely associated with a gain/loss to that particular lobby group.[356] In making the analysis in this thesis, the lobbying effort has been considered in respect of the submissions made to the Treasury and the PJCCFS. Submissions made by the Legal Practitioners and the External Commentators may be considered to be in this category. This is because these groups do not appear to directly benefit/lose from the introduction of the Relevant Proposals. The Legal Practitioners and the External Commentators are far more removed from the audit process as compared to those respective groups comprising the Selected Interest Groups. If the Legal Practitioners and the External Commentators were to achieve what they had requested for in their respective proposals as compared to the Accounting Associations, they are unlikely to get a direct benefit. It could be said that in submitting proposals that seek to benefit the public interest, the Legal Practitioners and the External Commentators could be perceived to be advocating for the public interest. This in itself could be considered a public relations exercise that can potentially enhance the reputations of the Legal Practitioners and the External Commentators at least from the public's perspective but there is no direct financial benefit to be gained from the changes that they may advocate. There appears to be no direct link as to what their respective motivations might be other than to conclude that in these circumstances it could be that these groups were

[355] Stigler, above n 11, 12, Peltzman, above n 29, Posner, above n 29 and Becker, above n 29.
[356] Stigler, above n 11, 12, Peltzman, above n 29, Posner, above n 29 and Becker, above n 29.

lobbying for less direct reputational reasons. On this basis, the Legal Practitioners and the External Commentators have been excluded from the Selected Interest Groups.

Whilst there are reasons why these submissions are ignored from the perspective of private interest theory, a review of the actual submissions indicates that the Legal Practitioners and the External Commentators have in many instances the same regulatory outcome in mind as the Selected Interest Groups.[357] In these instances, the Selected Interest Groups were successful in their lobbying efforts.[358]

There was only one occasion noted where the Legal Practitioners and the External Commentators advanced proposals against the lobbying efforts of the Selected Interest Groups.[359] This concerned the auditor rotation requirements. In this instance however, the Selected Interest Groups succeeded in their lobbying efforts and the proposals of the Legal Practitioners and the External Commentators were disregarded.[360]

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[357] For example, proposals from the Legal Practitioners and the External Commentators in relation to the the Annual Declaration were consistent with the successful lobbying efforts of the Accounting Associations. See Corrs Chambers Westgarth, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 21 November 2002, 3, Law Council of Australia, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 22 November 2002, 1 and Australian Auditors-General, Submission to the Treasury, *Exposure Draft Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 10 November 2003, 14. Likewise recommendations to limit the cooling off period to 2 years for Employment Relationships were consistent with the successful lobbying efforts of the Accounting Associations. See Corrs Chambers Westgarth, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 21 November 2002, 3 and The Institute of Internal Auditors, Submission to the Treasury, *Exposure Draft Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 14 November 2003, 2.

[358] The Accounting Associations were successful in their lobbying efforts in relation to the Annual Declaration, see National Institute of Accountants, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 25 November 2002, 15 and National Institute of Accountants, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 14 December 2003, 13 (hereinafter "National Institute of Accountants PJ") and to limit the cooling off period to 2 years for Employment Relationships, see CPA Australia, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 17 November 2003, 5 and Institute of Chartered Accountants in Australia, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 17 November 2003, 8.

[359] Proposals from the Legal Practitioners and the External Commentators for a 5 year rotation were eventually disregarded, namely Corrs Chambers Westgarth, above n 357, 5, Law Council of Australia, above n 357, 2 and the Australian Auditors-General, above n 357, 15.

[360] In contrast to the suggestions by the Legal Practitioners and the External Commentators, proposals from (for example) the Accounting Associations to extend the rotation period to exceed 5 years were accepted. See CPA Australia, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 25 November 2002, 10-11 and Institute of Chartered Accountants in

These findings provide additional support for excluding the Legal Practitioners and the External Commentators from detailed analysis. These results indicate that the regulatory outcomes in these instances are consistent with the successful lobbying efforts of the Selected Interest Groups rather than as a consequence of the proposals put forward by the Legal Practitioners and the External Commentators.

This is because there was only one occasion where both the Legal Practitioners and the External Commentators advanced proposals against the lobbying efforts of the Selected Interest Groups.[361] On this occasion, their efforts were ignored. These findings support the view that the Legal Practitioners and the External Commentators do not have any influence on the regulatory outcome of this topic.

Private interest research, such as that carried out by Stigler, Peltzman, Posner and Becker, have deliberately focused on the lobbying efforts of powerful interest groups (such as the Accounting Associations, Managers of Companies and Government Officials) that stand to gain or lose as a consequence of the regulatory process. [362] These commentators do not consider the public investor as an influential interest group. On the contrary, the public investor is considered as an ineffective lobby group that lacks the requisite resources to organise itself efficiently to lobby successfully for the public interest. The lack of these resources can cause the interests of the public investor (being the public interest) to be compromised.[363] On this basis, the Public Investors have been excluded.

A review of the actual submissions further support this exclusion. It was noted that the Public Investors had submitted proposals on two occasions.[364] These concerned the disclosure of non-audit services and the establishment of the Shareholders and Investors

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Australia, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 25 November 2002, 6.

[361] Proposals from the Legal Practitioners and the External Commentators for a 5 year rotation were eventually disregarded, namely Corrs Chambers Westgarth, above n 357, 5, Law Council of Australia, above n 357, 2 and the Australian Auditors-General, above n 357, 15.

[362] Stigler, above n 11, 12, Peltzman, above n 29, Posner, above n 29 and Becker, above n 29.

[363] Stigler, above n 11, 12, Peltzman, above n 29, Posner, above n 29 and Becker, above n 29.

[364] Australian Shareholders' Association Ltd, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 17 November 2003, 2 and 10 and The Australian Workers' Union, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, November 2003, 2.

Advisor Council. The findings indicate that in relation to the disclosure of non-audit services, both the Public Investors and the Selected Interest Groups had different regulatory proposals in mind and that both their regulatory proposals were dismissed by the government.[365] The findings also indicate that in relation to the establishment of the Shareholders and Investors Advisory Council, the Selected Interest Groups succeeded in their lobbying efforts and that the proposals of the Public Investors were disregarded.[366]

These findings provide additional support for excluding the Public Investors from detailed analysis. These results indicate that regulatory outcomes favour the Selected Interest Groups as opposed to the Public Investors. This is because based on the two occasions examined where the Public Investors had put forward their views, on both these occasions their efforts were ignored by the government. These findings support the view that the Public Investors do not have any influence on the regulatory outcome.

3.7 SUMMARY

This chapter provided support for the use of private interest theory as a measure to evaluate the current regime. Preliminary observations suggest that various interest groups may have lobbied to protect their respective interests. As such, private interest theory would potentially explain what has happened.

The public interest as discussed in Chapter 1, is the overriding theme for the six key CLERP principles. The key CLERP principles' strong emphasis on 'enhancing market integrity', 'ensuring that all investors have reasonable access to information', 'increasing the confidence of individual investors in the fairness and integrity of financial markets', 'providing necessary investor and consumer protection', 'applying regulation consistently

[365] For example, the Australian Shareholders' Association Ltd, above n 364, 2 and The Australian Workers' Union, above n 364 requested for outright prohibition of non-audit services, whereas the Accounting Associations advocated for adherence to the code of ethics, rather than mandatory disclosure, both of which were dismissed by the government. See CPA Australia, above n 360, 10, Institute of Chartered Accountants in Australia, above n 360, 14 and National Institute of Accountants, above n 358, 9.

[366] For example, the Australian Shareholders' Association Ltd, above n 364, 10 had provided support for the creation of the Council, but their suggestion was eventually disregarded whereas the Accounting Associations lobbied against the existence of such a Council and their proposal was ultimately accepted. See Institute of Chartered Accountants in Australia, above n 360, 22.

and fairly' and 'encouraging high standards of business practice and ethics', is directly associated with safeguarding the public interest.

As the key CLERP principles were intended to serve as a guide for future CLERP installments, the current legislation should be reviewed in circumstances where it is found to have digressed from its primary objective of safeguarding the public interest. This can occur in circumstances where the current legislation is found to have been developed to serve private interests rather than the stated goal of the public interest. The public interest may not have been the overriding consideration for the current regime but rather secondary to the respective interests of the Selected Interest Groups.

Private interest theory can explain whether CLERP 9 has been developed to serve private interests. The current regime can then be tested against the stated goal of the public interest. Private interest theory was selected to evaluate how the current regime came about because it is well placed to explain the reasons for the various interest groups (members of accounting professional bodies, managers of companies and government officials) to control and oversee the regulation of financial reporting. Private interest theory is suitable for evaluating the current regime as the Selected Interest Groups stand to benefit the most from controlling and overseeing the development of the current regime.

Commentators such as Stigler[367] and Peltzman,[368] have suggested that the development of the law can be associated with private interest theory. These commentators have introduced a promising approach that suggests what some of the key variables ought to be that can explain the regulatory process.

To put this simply, regulation can be viewed as a commodity. In order for this to occur, firstly, there must be in existence interest groups that would benefit from the introduction of the new regulation. These interest groups would therefore have an incentive to influence the regulatory process so as to benefit from the introduction of such regulation. Secondly, these interest groups would need to be compact, highly organized and have the available resources (time and money) to effectively lobby for their

[367] Stigler, above n 11.
[368] See generally, Peltzman, above n 29, 6-7.

respective interests. Finally, this means that the legislature must be able to be influenced by the lobbying efforts of the various interest groups. The greater the degree of democracy that exists, the higher the likelihood of private interest theory being applicable. This is because democracy provides a conducive environment for these key variables to thrive.

When these key variables exist, private interest theory comes into play. The commodity of regulation would, in some circumstances, be developed for those who value it most. This would mean that the resultant regulation could in some circumstances, be developed to serve the private interests of the various groups that are compact, highly organized and that have the available resources to lobby effectively for their respective interests. This outcome may not necessarily be in the public interest.

It is envisaged, through the use of private interest theory, this thesis can provide support for the argument that the auditor independence requirements in CLERP 9 were developed to serve private interests rather than the stated goal of the public interest. This way, legal reform can be proposed in the area of auditor independence, where the current legislation is found to serve private interests, rather than the public interest. On this view, proposals for legal reform can be specifically designed with the objective of advancing the public interest and need not necessarily be consistent with the original intentions of the various stakeholders (members of accounting professional bodies, managers of companies and government officials).

Now that the Selected Interest Groups have been identified, Chapter 4 will seek to determine the respective preferences of the Selected Interest Groups and examine how these preferences as far as independence is concerned are evident in legal reform. The Relevant Proposals, CLERP 9 Bill and Audit Enhancement Bill submissions from the Treasury and the JPCCFS as a result of the public consultation process will be used to ascertain this.

This will be achieved by analysing the respective preferences of the Selected Interest Groups under the following sub-headings: Members of accounting professional bodies (further divided into the following sub-groups: Accounting Associations, Big 4 Firms, Middle Tier Firms and Small Firms), Managers of companies (producer group)

and Government officials (being the APESB, AASB, CALDB, FRC, ASIC and the ASX).

Chapter 4: DOES PRIVATE INTEREST THEORY EXPLAIN HOW THE CURRENT REGIME WAS ESTABLISHED?

4.1 INTRODUCTION

This chapter will seek to determine whether any (or all) of the Selected Interest Groups have been successful in obtaining what they have lobbied for. For the purposes of this thesis, 'success' by a Selected Interest Group could mean either it has obtained what it has lobbied for or an outcome that is in substance what it has lobbied for.

This chapter will discuss how the Selected Interest Groups may have had an impact in controlling and overseeing the regulation of financial reporting under the sub-headings - Members of accounting professional bodies, Managers of companies (producer group) and Government officials. Submissions obtained from the Treasury and the JPCCFS as a result of the Relevant Proposals, CLERP 9 Bill and Audit Enhancement Bill public consultation process will be used to ascertain this. Each of these sub-headings will identify the relevant stakeholders influencing the current regime from the perspective of private interest theory, assess the preferences of these stakeholders as far as independence is concerned and the extent to which these preferences are evident in legal reform. The preferences of these stakeholders as far as independence is concerned will be assessed by reference to the Relevant Proposals raised by the various stakeholder(s).

The successful lobbying efforts by the Selected Interest Group(s) in relation to the Relevant Proposals in CLERP 9 were identified. Where the Relevant Proposals were subsequently amended by the Audit Enhancement Act, the successful lobbying efforts by the Selected Interest Group(s) were also identified. The Relevant Proposals subsequently amended by the Audit Enhancement Act specifically relate to the expanded FRC and auditor rotation proposals. As such, the impact of the initial lobbying by the Selected

Interest Groups in relation to the Relevant Proposals in CLERP 9 and the subsequent lobbying which resulted in the Audit Enhancement Act were both analysed.

The Relevant Proposals[369] are set out below:-

> **Expanded FRC**
>
> The Government will expand the responsibilities of the FRC, which currently oversees the accounting standard setting process, to oversee auditor independence requirements in Australia.[370]
>
> **General Statement of Principle requiring Independence**
>
> The Government will amend the Corporations Act to include a General Statement of Principle requiring the independence of auditors.[371]
>
> **Annual Declaration by Auditor**
>
> The Government will amend the law to require the auditor to make an annual declaration that they have maintained their independence.[372]
>
> **Employment Relationships**
>
> The Government will amend the law to strengthen restrictions on employment relationships between an auditor and the audit client. This will include a mandatory period of 2 years following resignation from an audit firm before a former partner who was directly involved in the audit of a client can become a director of the client or take a position with the client involving responsibility for fundamental management decisions.[373]

[369] The CLERP 9 Policy Paper contained (amongst other things) 41 proposals in relation to CLERP 9. The Relevant Proposals comprised of legal reform for an expanded FRC, a general statement of principle requiring independence, an annual auditor declaration, employment relationships, financial relationships, non-audit services, auditor rotation, the expansion of auditors' duties, streamlining auditor discipline arrangements and the establishment of a shareholders and investors advisory council. These proposals were intended to be general in nature for all stakeholders to grasp essentially where corporate legal reform was heading whilst the fine tuning was intentionally left for future deliberation being the CLERP 9 Bill. Treasury, above n 26.
[370] Ibid 1.
[371] Ibid 2.
[372] Ibid.
[373] Ibid.

Financial Relationships

The Government will amend the law to impose new restrictions on financial relationships. This will cover investments in audit clients and loans between an audit client, and the auditor or the auditor's immediate family.[374]

Non-Audit Services

The Government will implement a series of measures to deal with non-audit services. It will:-

- Amend the law to require mandatory disclosure in the annual report of fees paid for the categories of non-audit services provided.[375]
- Amend the law to require a statement in the annual report of whether the audit committee is satisfied the provision of non-audit services is compatible with auditor independence. This disclosure would include an explanation as to why the non-audit services referred to in F1, if contracted, do not compromise auditor independence.[376]

Auditor Rotation

The Government will make audit partner rotation compulsory after 5 years. The new requirement will apply to the lead engagement partner and the review partner. To maintain continuity of knowledge, the appointment of these partners could be staggered.[377]

Auditors' Duties Expanded

The Government will amend the law to expand matters which auditors must report to ASIC to include any attempt to influence, coerce, manipulate or mislead the auditor.[378]

[374] Ibid 3.
[375] Ibid.
[376] Ibid.
[377] Ibid 4.
[378] Ibid 8.

Streamline Auditor Discipline Arrangements

The institutional arrangements for taking disciplinary action against registered company auditors will be strengthened to (amongst other things) provide a majority of members of the CALDB, with appropriate skills, who are non-accountants.[379]

Shareholders and Investors Advisory Council

The Government will establish a Shareholders and Investors Advisory Council, to be chaired by the Parliamentary Secretary to the Treasurer, which it will consult on all disclosure-related reforms to ensure they meet the needs of retail investors.[380]

4.2 MEMBERS OF ACCOUNTING PROFESSIONAL BODIES

This section determines whether the members of the Australian accounting professional bodies have had an influence in the development of the current regime. Factors that may influence their decision to lobby for or against legal reform in relation to auditor independence includes (amongst other things) potential loss of recurring fees from audit and/or non-audit clients, increase in audit costs as a result of more stringent legislation for auditors (for example, compulsory auditor rotations for listed entities) which may lead to a decrease in profits for audit firms and legal reform aimed at curbing or reducing their influence in the audit standard setting process.

These stakeholders have been further subdivided into smaller groups. These groups consist of the Accounting Associations, Big 4 Firms, Middle Tier Firms and Small Firms. The Accounting Associations are grouped together because these associations have provided (amongst other submissions) joint submissions, collectively representing all 3 associations. These associations also have common interests. One such common interest is to increase or at the very least, to maintain their respective influence in the audit standard setting process. Failure to maintain this influence can lead to their eventual lack of relevance and subsequent demise. In relation to the Big 4 Firms, Middle Tier Firms

[379] Ibid.
[380] Ibid.

and Small Firms categories, these accounting firms have been grouped together accordingly based on the way they have described themselves in their respective submissions.

There is only one instance where the Accounting Associations, Big 4 Firms and several representatives from the Middle Tier Firms aligned themselves to form a group (known as the Australian Public Policy Committee ("**APPC**")) that lobbied in relation to the Expanded FRC and the Auditor Rotation requirements.[381] Their combined lobbying efforts are noted under the heading Australian Public Policy Committee below.

4.2.1 Accounting Associations

This group consists of the CPA, the Institute and the IPA (formerly known as the 'National Institute of Accountants').

Expanded FRC

The CPA did not support the FRC undertaking monitoring of the Accounting Associations. According to the CPA, it would be more effective for the FRC to focus on oversight and to have the monitoring function instead carried out by a newly created body. The CPA proposed that this separate entity could be funded by the users of financial information and in fulfilling this monitoring role could promote independence, transparency and public accountability.[382]

The IPA was seeking to replace the words 'monitor and review' to 'working with' the Accounting Associations. The IPA was concerned that the words 'monitor and review' the Accounting Associations would empower the FRC to regulate the internal policy decisions of the Accounting Associations and to decide upon such matters which would ordinarily be the responsibility of the respective Accounting Associations. According to the IPA, the FRC should 'facilitate discussion of issues surrounding auditor

[381] Australian Public Policy Committee, Submission to the Treasury, *Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth)*, 31 October 2011, 1-2.
[382] CPA Australia, above n 360, 7.

independence issues and that it should work in conjunction with, not over the top of' the Accounting Associations.[383]

CLERP 9 provided the FRC with the jurisdiction to oversee and monitor the auditor independence requirements in Australia.[384] Despite this however, ASIC and the Accounting Associations are the entities responsible for the enforcement of auditor independence requirements and not the FRC. ASIC is responsible for enforcement of the auditor independence requirements in the Corporations Act whilst the Accounting Associations have assumed the responsibility for enforcement of these requirements in their respective codes of professional conduct.[385] The explanatory memorandum however was silent as to the reasons for allowing ASIC and the professional accounting bodies to be responsible for the enforcement of auditor independence requirements.

With the enactment of the Audit Enhancement Act, the FRC became responsible for overseeing the auditor independence requirements as well as taking on a new role of providing strategic policy advice in relation to such requirements to the Treasurer.[386] The new law replaced the FRC's existing monitoring role in relation to the auditor independence requirements in Australia. This new responsibility gives the FRC the ability to advise the government on high level strategic policy matters in relation to all issues regarding auditor independence (including compliance with the Corporations Act and the respective codes of professional conduct used by the Accounting Associations).[387] With the abolishment of the FRC's existing auditor independence monitoring role, the FRC can only seek information regarding auditor independence matters from the Accounting Associations.[388] Despite FRC's role in providing advice on auditor independence, enforcement of auditor independence requirements is the

[383] National Institute of Accountants PJ, above n 358, Executive Summary 2.
[384] ASIC Act s 225(1)(a),(b) and (c).
[385] Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) 88. It is important to note that the subsequent enactment of the Audit Enhancement Act has not altered this responsibility. The jurisdiction to enforce the auditor independent requirements still stays with ASIC or the Accounting Associations (depending on whether the independence requirement is contained in the Corporations Act or in the ethical codes of conduct of the Accounting Associations).
[386] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[387] Ibid.
[388] Ibid.

responsibility of either ASIC (where there is an alleged breach of the Corporations Act) or the Accounting Associations (where there is an alleged contravention of the professional code of conduct), rather than of the FRC.[389]

With the enactment of the Audit Enhancement Act, the Accounting Associations were generally successful in their lobbying efforts for the FRC to focus on oversight and not to 'monitor and review' the operations of the Accounting Associations.[390] By providing strategic policy advice in relation to (amongst other things) the auditor independence requirements in the Corporations Act, the FRC would not be seen to regulate the internal policy decisions of the Accounting Associations and to decide upon such matters which would ordinarily be the responsibility of the respective Accounting Associations. The role of the FRC instead could be perceived to 'facilitate the discussion of the issues surrounding auditor independence' and can also be perceived to 'work in conjunction with, not over the top of' the Accounting Associations to promote auditor independence.[391]

It would appear that the Accounting Associations were also generally successful in their lobbying efforts to maintain their influence in the enforcement of auditor independence requirements. The Accounting Associations still retain responsibility for the enforcement of auditor independence requirements via their respective codes of professional conduct.

The Institute and the IPA were of the view that the FRC should include representatives that had suitable audit skills and expertise.[392] In addition, the IPA was of the view that the FRC should comprise key stakeholders including a representative from the IPA.[393]

The *Australian Securities and Investments Commission Act 2001* (Cth) referred to as the ASIC Act stipulates that the FRC comprise of members to be determined by the

[389] du Plessis, McConvill and Bagaric, above n 5, 257.
[390] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[391] National Institute of Accountants PJ, above n 358, Executive Summary 2.
[392] Institute of Chartered Accountants in Australia, above n 360, 4 and National Institute of Accountants, above n 358, 7.
[393] National Institute of Accountants, above n 358, 5.

Treasurer.[394] The ASIC Act provides indirect support for the appointment of FRC members from key stakeholder groups in addition to those that are appointed independently and are not associated with such groups as the ASIC Act states (amongst other things) that 'the Minister may appoint a person by specifying an organisation or body that is to choose the person who is appointed.'[395]

It would also appear that the Accounting Associations were generally successful in their lobbying efforts to maintain their influence on the FRC by securing membership on the FRC as can be seen in the current composition of the FRC.[396] The Treasurer has determined that the current membership of the FRC comprise of 16 members and that the CPA, the Institute and the IPA nominate 1 member each.

General Statement of Principle requiring Independence

The CPA and the Institute supported this proposal but were of the view that compliance with the code of ethics for professional accountants[397] should be in the definition adopted in CLERP 9. This is because the code of ethics for professional accountants is more comprehensive in that it broadly sets out the general independence requirements applicable to all members of the CPA and the Institute.[398] The IPA also supported the general definition of auditor independence but was of the view that the auditor independence requirements prescribed by the International Federation of Accountants and adhered to by the Accounting Associations should be adopted instead of the general definition in CLERP 9.[399]

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[394] ASIC Act s 235A(1).
[395] ASIC Act s 235A(1).
[396] FRC, *Members as at 25 January 2014* <http://www.frc.gov.au/about/members.asp>. Three members from the current FRC membership comprise of representatives from each of the Accounting Associations. The other members were nominated by the Commonwealth, Australian Institute of Company Directors, Business Council of Australia, Group of 100, Financial Services Council, ASFA, Australian Prudential Regulation Authority, ASX, ASIC and the New Zealand Minister of Commerce.
[397] Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2013) Section 290 has replaced CPA Australia and Institute of Chartered Accountants in Australia, *Professional Statement F1 Professional Independence* (2006) from 1 July 2006. See FRC, *FRC Report on Auditor Independence 2005-2006* <http://www.frc.gov.au/reports/2005 2006 aair/frc air 2005 2006-05.asp>.
[398] FRC, above n 397.
[399] National Institute of Accountants PJ, above n 358, Executive Summary 3.

The CPA explained their reservations to this proposal by providing 2 reasons. Firstly, on their view a potential for conflict exists between these specific auditor independence restrictions in CLERP 9 and those prescribed by the code of ethics for professional accountants, the latter requirements being more general in nature and therefore more suitable for a wider range of circumstances. Secondly, the CPA was concerned that the identification of specific auditor independence restrictions in CLERP 9 increased the likelihood that these specific restrictions would be given priority at the expense of 'a general recognition of the need to assess and manage all risks to independence'.[400] The code of ethics for professional accountants adopts the latter approach which is consistent with the professional obligation by CPA members to comply with 'substance over form'.[401]

The Corporations Act sets out a general requirement for auditor independence[402] and prohibits the auditor from auditing the auditee in specific circumstances.[403] The Accounting Associations were not successful in their lobbying efforts in this regard as the code of ethics for professional accountants was not adopted in CLERP 9 and neither were the International Federation of Accountants rules on auditor independence.[404]

Annual Declaration by Auditor

The IPA supported this proposal subject to the inclusion of the IPA Code of Ethics in the declaration of the auditor. In addition, the proposal should be broad enough to be able to accommodate for qualified declarations to be issued in circumstances where a contravention of the code of ethics has occurred. This way the auditor can still 'provide a declaration that states the circumstance of any breach rather than the auditor simply not making a statement, which may require the auditor to step down and cause problems for the audit process'.[405]

[400] CPA Australia, above n 360, 9.
[401] Ibid.
[402] Corporations Act s 324CA.
[403] Ibid s 324CA(1).
[404] Ibid s 324CA.
[405] National Institute of Accountants, above n 358 and National Institute of Accountants PJ, above n 358.

The Corporations Act requires an auditor to give the company a written declaration that the auditor has not contravened any of the auditor independence requirements of the Corporations Act and any applicable code of professional conduct.[406] The Accounting Associations were successful in their lobbying efforts in this regard as the Corporations Act requires that the written auditor independence declaration contain (amongst other things) a statement that the auditor complies with his/her respective code of professional conduct. In addition, the Corporations Act allows for a qualified declaration to be made. The original proposal[407] for a written declaration by the individual auditor may not have envisaged the need for a qualified declaration.

Employment Relationships

The CPA and the Institute recommended 'cooling off periods' of '2 years for partners and key senior members of the audit team'.[408] The IPA recommended a 'cooling off period' of '2 years for audit partners only'.[409]

The Corporations Act prohibits a person from becoming an officer of the audited body for 2 years where the person ceases to be a member of an audit firm or director of an audit company and was a 'professional member of the audit team' for the audit.[410] The Corporations Act defines a 'professional member of the audit team' as the individual auditor who conducts the audit, any person who 'exercises professional judgment' concerning accounts, audit or legal requirements and/or any person who is capable of directly influencing the audit.[411]

The Accounting Associations were generally successful in their lobbying efforts in this regard as the restrictions applying to employment relationships between auditors and audited bodies have been limited to partners and key senior members of the audit team as these are the members of the audit team that conduct the audit, exercise professional judgment concerning accounts, audit or legal requirements and are capable of directly

[406] Corporations Act s307C(1).
[407] Treasury, above n 26.
[408] CPA Australia, above n 358 and Institute of Chartered Accountants in Australia, above n 358.
[409] National Institute of Accountants PJ, above n 358, 14.
[410] Corporations Act s324CI.
[411] Ibid s 324AE.

influencing the audit.[412] The original proposal may not have envisaged the need for limiting the restrictions to partners and key senior members of the audit team.

Financial Relationships

The CPA and the Institute recommended that the definition of 'immediate family member' that applied to financial relationships between the auditor and the auditee should be replaced with that used overseas that is 'spouse and dependents'.[413] The Corporations Act prohibits an individual auditor from auditing an auditee where the auditor or the auditor's immediate family has entered into a financial relationship with the auditee at a particular time.[414]

The Accounting Associations were not successful in their lobbying efforts in this regard as the definition of 'immediate family member' has not been replaced with that used overseas that is 'spouse and dependents'.[415] The government remained silent as to why such specific wording was to be used. It was however of the view that financial relationships should be prescribed in the Corporations Act as these could potentially enhance both actual and perceived auditor independence.[416]

Non-Audit Services

The CPA and the Institute believed that the code of ethics for professional accountants (to be adhered to by members of the CPA and the Institute) adequately provides for all threats to independence and as such this proposal should refer to compliance with this code and the CPA had objected to the proposal for a listed entity to disclose all non-audit services provided by the external auditor of the entity.[417] The IPA

[412] Corporations Act s 324CI and s 324AE.
[413] CPA Australia, above n 358 and Institute of Chartered Accountants in Australia, above n 358.
[414] Corporations Act s324CE(1).
[415] Ibid s 324CE(5) and s 324CH(1).
[416] Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) 14-15.
[417] CPA Australia, above n 360, 10 and Institute of Chartered Accountants in Australia, above n 360, 14.

also supported this view and further suggested that reference should also be made to the IPA's Code of Ethics in addition to the code of ethics for professional accountants.[418]

The Corporations Act requires listed companies to disclose non-audit services that have been provided in the company's annual report. The information to be disclosed includes details of the amounts paid or payable to the auditor for non-audit services provided and a statement from the directors stating that the provision of the non-audit services does not compromise the auditor independence requirements of the Corporations Act.[419] Where the listed entity has an audit committee, this statement must be made in accordance with advice provided by the listed entity's audit committee.[420]

The Accounting Associations were unsuccessful in their lobbying efforts in this regard as the threats to independence (the inclusion of a list of non-audit services) still need to be specified in the company's annual report.[421]

Auditor Rotation

The CPA questioned the 5 year requirement when the norm overseas (other than the US) was 7 years. The CPA recommended that the auditor rotation requirement should be reviewed at the end of every 7 years. Where a decision is made during such a review to reappoint the existing audit firm, audit partner rotation should be allowed to take place.[422]

The Institute likewise did not support this proposal. The Institute commented that no explanation was provided in the CLERP 9 Policy Paper for the 5 year audit partner rotation instead of the 7 year requirement as proposed by the code of ethics for professional accountants and the Ramsay Report.[423]

The CPA and the Institute further stated that the adoption of this proposal to every listed company does not take into account the size of each company and in particular the

[418] National Institute of Accountants, above n 358, 9.
[419] Corporations Act s300(11B).
[420] Ibid s300(11D).
[421] Ibid s300(11B).
[422] CPA Australia, above n 360.
[423] Institute of Chartered Accountants in Australia, above n 360.

SMEs.[424] The IPA on the other hand, did not object to the reduction from 7 years to 5 years for lead engagement and review partner rotation and supported the adoption of this proposal to all listed companies.[425]

The Corporations Act sets out the requirements for auditor rotation by prohibiting the lead engagement or review partner who has acted as an external auditor for the listed company for 5 successive financial years from continuing to act as an external auditor for that company for at least another 2 successive financial years.[426]

The Accounting Associations were initially generally unsuccessful (with the exception of the IPA) in their lobbying efforts for an increase from 5 years to 7 years for lead engagement and review partner rotation as the earlier amendment to the Corporations Act required that the lead engagement and review partner acting in the capacity of the external auditor for the listed company rotate after 5 years.[427]

With the enactment of the Audit Enhancement Act however, the Accounting Associations were generally successful (including the IPA which has since changed its position and has supported the extension) in their lobbying efforts for an increase from 5 years to 7 years for lead engagement and review partner rotation as the amended Corporations Act enables the directors to allow the lead engagement or review partner who has acted as an external auditor for the listed company for 5 successive financial years to continue to act in such a capacity for up to a further 2 years provided that the auditor independence requirements are complied with.[428]

Auditors' Duties Expanded

The CPA did not agree with the proposal to expand the duties of auditors to report to ASIC any attempt to 'influence' the auditor. The CPA was of the view that this 'may

[424] CPA Australia, above n 358 and Institute of Chartered Accountants in Australia, above n 358, 9.
[425] National Institute of Accountants PJ, above n 358, 24-25.
[426] Corporations Act s324DA .
[427] Ibid.
[428] CPA Australia, Institute of Chartered Accountants in Australia and the Institute of Public Accountants, Joint Submission to the Treasury, *Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth)*, 28 October 2011, 3 and Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 4 and Audit Enhancement Act Schedule 1 Part 1 item 7.

diminish the willingness of auditors and their clients to engage in robust and frank discussion of key issues such as the selection of accounting policies'.[429]

In addition, the CPA believed that this proposal should require the external auditor to notify the audit committee or the board at first instance of such an attempt. ASIC should only be notified when the audit committee or the board has not taken any remedial action.[430]

Both the CPA and the Institute were of the view that this provision was too broad as it applied to all audits and it did not differentiate the SMEs.[431] The Corporations Act requires that the financial statements of large proprietary companies be audited.[432] The Institute noted that 'most large proprietary companies (in the regional areas at least) are still closely controlled by a family or dominant related group of persons'.[433] The Institute was concerned that this proposal was not applicable to such companies and costly to implement with no actual benefit to be gained.[434]

The Corporations Act requires an individual auditor conducting an audit to notify ASIC in writing within 28 days after the auditor becomes aware of any circumstances (amongst other things) that amount to an attempt, in relation to the audit, by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit.[435] The Corporations Act also requires audited financial statements to be prepared for each financial year by all public companies as well as large proprietary companies.[436]

The Accounting Associations were unsuccessful in their lobbying efforts in this regard. The auditors' duties have been expanded to include the reporting to ASIC of any attempt to 'influence' the auditor[437] and that large proprietary companies are not exempt from this requirement.[438]

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[429] CPA Australia, above n 360, 17.
[430] Ibid.
[431] CPA Australia, above n 358, 3 and Institute of Chartered Accountants in Australia, above n 358, 5.
[432] See Corporations Act ss 285, 292 and 301 and ASIC's power to exempt in Corporations Act ss 340-342.
[433] Ibid.
[434] Ibid.
[435] Corporations Act s 311.
[436] Ibid s 292(1).
[437] Ibid s 311.
[438] Ibid s 292(1).

Streamline Auditor Discipline Arrangements

The Institute believed that members of the CALDB should possess the requisite audit expertise in order to apply the relevant audit standards to be considered.[439] The Institute and the IPA had reservations about the suitability of a CALDB comprised of a majority of non-accountants.[440]

Members of the CALDB are appointed by the Treasurer pursuant to the ASIC Act. The CALDB consists of a Chairperson (a lawyer), a Deputy Chairperson (also a lawyer), 6 'accounting members' (accountants) and 6 'business members' as representatives of the business industry (who possess the requisite skills and experience in the specified category(ies)).[441]

It would appear that the Accounting Associations were generally successful in their lobbying efforts to maintain their influence on the CALDB by securing membership on the CALDB as can be seen in the current composition of the CALDB. The ASIC Act has stipulated that the current membership of the CALDB comprise of 14 members and that the 6 'accounting members' comprise of representatives from a 'professional accounting body' which could mean either the CPA, the Institute and/or the IPA.[442] The ASIC Act has also stipulated that the 6 'business members comprise of representatives from the business community that have qualifications in, knowledge of or experience in one or more of the specified fields being business or commerce, the administration of companies, financial markets, financial products & financial services, economics or

[439] Institute of Chartered Accountants in Australia, above n 360 , 5.
[440] Ibid and National Institute of Accountants PJ, above n 358, 30. The CALDB has been criticized for not being independent (in appearance) from ASIC as it can only hear matters referred to by ASIC and is funded by ASIC. See Senate Economics References Committee, Parliament of Australia, *The regulation, registration and remuneration of insolvency practitioners in Australia: the case for a new framework* (September, 2010) 75. Commentators have also argued that the CALDB has in the past deliberated on very few serious matters (See David Brown and Christopher Symes, Submission to the Senate Standing Committee on Economics, *Senate Inquiry to investigate the role of liquidators and administrators*, (undated), 4 and Institute of Chartered Accountants in Australia, Submission to the Senate Standing Committee on Economics, *Senate Inquiry to investigate the role of liquidators and administrators*, 12 February 2010, 5) and that the CALDB's private hearings should instead be open to public scrutiny. See Australian Institute of Company Directors, *CALDB could use some transparency Accounting* (1 February 2001) <http://www.companydirectors.com.au/Director-Resource-Centre/Publications/Company-Director-magazine/2000-to-2009-back-editions/2001/February/CALDB-could-use-some-transparency-Accounting>.
[441] ASIC Act s 203.
[442] Ibid.

law'.[443] This means that additional members from the Accounting Associations (from the CPA, the Institute and/or the IPA) can be appointed as a business member as long as that person fulfils the requisite criteria as a business member. Members from the Accounting Associations are not excluded from being appointed as a business member. The composition of the CALDB is therefore not restricted to a majority of non-accountants.

Shareholders and Investors Advisory Council

The Institute did not consider it necessary for the creation of a new entity to evaluate reforms in relation to disclosure.[444] The Institute was not successful in its lobbying efforts in this regard as to the establishment of a Shareholders and Investors Advisory Council. The establishment of the Shareholders and Investors Advisory Council was announced on 21 June 2004.[445] According to the Treasury, the Shareholders and Investors Advisory Council was created to 'inform the Government on developments and issues affecting retail investors and provide advice and feedback to the Government on development of policies and strategies, on issues of corporate disclosure and governance as they relate to retail investors'.[446] The successful lobbying efforts of the Accounting Associations provide support for the subsequent cessation of the Shareholders and Investors Advisory Council.[447]

4.2.2 Big 4 Firms

This group consists of Deloitte, EY, KPMG and PWC.

[443] Ibid.
[444] Institute of Chartered Accountants in Australia, above n 360, 22.
[445] Treasury, *Press Release – Establishment of the Shareholders and Investors Advisory Council* (June 2004) <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2004/021.htm&pageID=003&min=rac&Year=&DocType=0>.
[446] Ibid.
[447] Ibid. Treasury has confirmed that the Shareholders and Investors Advisory Council was established in 2004, to be chaired by the Parliamentary Secretary to the Treasurer. The meetings of the Shareholders and Investors Advisory Council however proved to be unproductive and as such, it ceased to exist shortly after its creation. Personal email from Richard Chung (Treasury) to Kelvin Kuan, 3 August 2011.

Expanded FRC

Deloitte stressed that the FRC should focus on overseeing the auditor independence requirements and that the FRC should not be involved in the direct monitoring of such requirements.[448] KPMG was of the view that the Accounting Associations should continue to assume key responsibility for the direct monitoring of auditor independence through its existing self-regulatory mechanisms.[449]

With the enactment of the Audit Enhancement Act, the Big 4 Firms were generally successful in their lobbying efforts for the FRC to focus on oversight and not direct monitoring.[450] By providing strategic policy advice in relation to (amongst other things) the auditor independence requirements in the Corporations Act, the FRC would not be seen to regulate the internal policy decisions of the Accounting Associations and to decide for those bodies. The role of the FRC instead can be perceived to 'facilitate the discussion of the issues surrounding auditor independence' and can also be perceived to 'work in conjunction with, not over the top of' the Accounting Associations to promote auditor independence.[451]

It would appear that the Big 4 Firms were also generally successful in their lobbying efforts to maintain the Accounting Associations' influence in the enforcement of auditor independence requirements. The Accounting Associations still retain responsibility for the enforcement of auditor independence requirements via their respective codes of professional conduct.

General Statement of Principle requiring Independence

Deloitte and KPMG were of the view that compliance with the code of ethics for professional accountants was a more appropriate alternative than to prescribe a set of restrictions as set out in CLERP 9. This is because the code of ethics for professional

[448] Deloitte Touche Tohmatsu, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework* , 22 November 2002, 3.
[449] KPMG, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 25 November 2002, 5.
[450] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[451] National Institute of Accountants PJ, above n 358, Executive Summary 2.

accountants contained a more suitable mechanism to address auditor independence issues.[452] Deloitte, EY and KPMG supported the general definition of auditor independence however, compliance with the code of ethics for professional accountants should have been in the definition adopted in CLERP 9.[453]

The Big 4 Firms were not successful in their lobbying efforts in this regard as the Corporations Act stipulates a general requirement for auditor independence instead of adopting the code of ethics for professional accountants.[454]

Annual Declaration by Auditor

Deloitte and KPMG were of the view that this proposal could have been catered for via the ethical and professional codes of conduct for accountants rather than in legislation.[455] The Big 4 Firms were not successful in their lobbying efforts in this regard as the Corporations Act requires a written declaration by the individual auditor, that there have been no contraventions of the auditor independence requirements of the Corporations Act and any applicable code of professional conduct in relation to the audit or review and that any contravention is to be set out in the declaration.[456]

Employment Relationships

Deloitte recommended decreasing the 'cooling off' periods to 'less than the proposed 4 years for partners and key senior members of the audit team'.[457] EY recommended 'cooling off' periods of '2 years for partners and key senior members of the audit team'.[458] PWC recommended 'cooling off' periods of '2 years for partners'.[459]

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[452] Deloitte Touche Tohmatsu, above n 448, 5 and KPMG, above n 449, 7.
[453] Deloitte Touche Tohmatsu, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 17 November 2003, 3, Ernst & Young, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, November 2003, 2 and KPMG, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 17 November 2003, 2.
[454] Corporations Act s 324CA.
[455] Deloitte Touche Tohmatsu, above n 448, 5 and KPMG, above n 449, 8.
[456] Corporations Act s 307C(1).
[457] Deloitte Touche Tohmatsu, above n 453, 4.
[458] Ernst & Young, above n 453, 3.

The Big 4 Firms were successful in their lobbying efforts in this regard as the restrictions applying to employment relationships between auditors and audited bodies have been limited to partners and key senior members of the audit team as these are the members of the audit team that conduct the audit, exercise professional judgment concerning accounts, audit or legal requirements and are capable of directly influencing the audit.[460]

Financial Relationships

Deloitte and EY were of the view that imposing additional obligations in relation to financial relationships were unnecessary as the code of ethics for professional accountants already provided for these relationships. As a consequence, they recommended that the Corporations Act should instead refer to the relevant rules regulating financial relationships prescribed by the code of ethics for professional accountants.[461] This view was also endorsed by KPMG and PWC.[462] In addition, Deloitte, EY and KPMG recommended replacing the definition of 'immediate family member' to that used overseas that was 'spouse and dependents'.[463]

The Big 4 Firms were not successful in their lobbying efforts in this regard as the Corporations Act currently introduces additional obligations on financial relationships and does not replace the definition of 'immediate family member' with that used overseas that was 'spouse and dependents'.[464]

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[459] PricewaterhouseCoopers, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 17 November 2003, 2.
[460] Corporations Act s 324CI and s 324AE.
[461] Deloitte Touche Tohmatsu, above n 448, 6 and Ernst & Young, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework* , 22 November 2002, 5.
[462] KPMG, above n 449, 9 and PricewaterhouseCoopers, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework* , 22 November 2002, 21.
[463] Deloitte Touche Tohmatsu, above n 453, 5, Ernst & Young, above n 453, 3 and KPMG, above n 453, 4.
[464] Corporations Act s 324CE(5) and s 324CH(1).

Non-Audit Services

Deloitte proposed that any amendments to the disclosure requirements should be introduced through existing standards such as Accounting Standard AASB 1034 'Financial Report Presentation and Disclosures' that required the disclosure of non-audit fees paid to the external auditor.[465] KPMG and PWC were both of the view that this proposal should be considered by the Accounting Associations and should not be incorporated into legislation.[466]

The Big 4 Firms were unsuccessful in their lobbying efforts for the regulation of non-audit services to be considered by the Accounting Associations and not to be incorporated into legislation.[467] The Corporations Act currently regulates the provision of non-audit services as it requires listed companies to disclose non-audit services that have been provided in the company's annual report including details of the amounts paid or payable to the auditor for non-audit services provided and a statement from the directors stating that the provision of the non-audit services does not compromise the auditor independence requirements of the Corporations Act.[468]

Auditor Rotation

Deloitte, KPMG and PWC supported the adoption of the code of ethics for professional accountants which stipulated lead engagement partner rotation after 7 years.[469] KPMG commented that auditor rotation should not apply to the review partner in addition to the lead engagement partner. According to KPMG, this may encourage external auditors for SMEs to avoid having a review partner altogether so that this rotation requirement need not be fulfilled. The removal of a review partner in such circumstances can potentially lead to a decrease in the quality of the audit.[470]

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[465] Deloitte Touche Tohmatsu, above n 448, 7.
[466] KPMG, above n 449, 9 and PricewaterhouseCoopers, above n 462, 22.
[467] Corporations Act s 300(11B).
[468] Ibid s300(11B).
[469] Deloitte Touche Tohmatsu, above n 448, 8, KPMG, above n 449, 11 and PricewaterhouseCoopers, above n 462, 5.
[470] KPMG, above n 449, 12.

The Big 4 Firms were initially unsuccessful in their lobbying efforts for an increase from 5 years to 7 years for lead engagement partner and review partner rotation as the earlier amendment to the Corporations Act required that the lead engagement and review partner acting in the capacity of the external auditor for the listed company rotate after 5 years.[471]

With the enactment of the Audit Enhancement Act however, the Big 4 Firms were generally successful in their lobbying efforts for an increase from 5 years to 7 years for lead engagement partner and review partner rotation as the amended Corporations Act enables the directors to allow the lead engagement or review partner who has acted as an external auditor for the listed company for 5 successive financial years to continue to act in such a capacity for up to a further 2 years provided that the auditor independence requirements are complied with.[472]

Auditors' Duties Expanded

Deloitte proposed that it should only be a contravention of the Corporations Act to '*fraudulently induce*, coerce, manipulate or mislead the auditor' in relation to this proposal.[473] KPMG recommended that it should be a contravention of the Corporations Act to '*fraudulently* influence, coerce, manipulate or mislead the auditor'.[474] EY was of the view that expanding the auditors' duties to report to ASIC matters that include 'attempts to influence, coerce or manipulate' would be problematic as the practical application of this broad provision would be difficult.[475] PWC shared these concerns in that 'what constituted attempts to influence, coerce, manipulate or mislead' may be open to various interpretations and therefore difficult to determine.[476]

[471] Corporations Act s324DA .
[472] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 4 and Audit Enhancement Act Schedule 1 Part 1 item 7.
[473] Deloitte Touche Tohmatsu, above n 448, 15.
[474] KPMG, above n 449, 21.
[475] Ernst & Young, above n 461, 8.
[476] PricewaterhouseCoopers, above n 462, 24.

The Big 4 Firms were unsuccessful in their lobbying efforts in this regard. The auditors' duties have been expanded to include the reporting to ASIC of any attempt 'to unduly influence, coerce, manipulate or mislead' the auditor.[477]

Streamline Auditor Discipline Arrangements

Deloitte, EY, KPMG and PWC had concerns that non-accountants may not have the requisite expertise to determine audit matters raised at the hearings convened by the CALDB.[478] It would appear that the Big 4 Firms were generally successful in their lobbying efforts to prevent a majority of non-accountants being represented on the board of the CALDB as can be seen in the current composition of the CALDB.

The ASIC Act has stipulated that the current membership of the CALDB comprise of 14 members and that the 6 'accounting members' comprise of representatives from a 'professional accounting body' which could mean either the CPA, the Institute and/or the IPA.[479] This will result in at least 6 members of the CALDB comprising at all times of accountants that have the appropriate skills to evaluate matters which are presented to the CALDB. Members from the Accounting Associations are not excluded from being separately appointed as a business member as long as that person fulfils the requisite criteria as a business member.[480] The composition of the CALDB is therefore not restricted to a majority of non-accountants.

Shareholders and Investors Advisory Council

Deloitte and EY supported this proposal.[481] The Big 4 Firms were successful in their lobbying efforts in this regard as to the establishment of a Shareholders and Investors Advisory Council which was announced on 21 June 2004.[482]

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[477] Corporations Act s 311.
[478] Deloitte Touche Tohmatsu, above n 448, 16, Ernst & Young, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 22 November 2002, 8, KPMG, above n 449, 21 and PricewaterhouseCoopers, above n 462, 24.
[479] ASIC Act s 203.
[480] Ibid.
[481] Deloitte Touche Tohmatsu, above n 448, 16 and Ernst & Young, above n 461, 8.
[482] Treasury, above n 445.

4.2.3 Middle Tier Firms

This group consists of BDO, GT, PP, the Joint Submission, PKF and Stockford.

Expanded FRC

Stockford advocated for the FRC to assume a 'non-intrusive' oversight role that utilised the existing mechanisms that have been adopted by the Accounting Associations.[483] According to Stockford, the Accounting Associations can use their respective self-regulatory mechanisms already in place to monitor the auditor independence requirements and report to the FRC on the status of compliance (or non-compliance, as the case may be) of their respective members.[484] With the enactment of the Audit Enhancement Act, the FRC's role (amongst other things) is to focus on oversight and not direct monitoring of the effectiveness of auditor independence requirements in Australia.[485] The Middle Tier Firms were successful in their lobbying efforts in this regard as the FRC's focus on oversight is consistent with the 'non-intrusive' approach advocated by them.[486] This is because the FRC is no longer required to monitor the effectiveness of auditor independence requirements in Australia. By providing strategic policy advice in relation to (amongst other things) the auditor independence requirements in the Corporations Act, the role of the FRC instead can be perceived to utilise the existing activities of the Accounting Associations. This can be attained not only by the Accounting Associations reporting to the FRC on the status of compliance of the auditor independence requirements but also as a result of such strategic policy advice which can 'facilitate the discussion of the issues surrounding auditor independence'.[487] As a consequence of such advice, the FRC can be perceived to 'work

[483] Stockford Accounting Services Pty Ltd, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 15 November 2002, 8.
[484] Ibid.
[485] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[486] Stockford Accounting Services Pty Ltd, above n 483.
[487] National Institute of Accountants PJ, above n 358, Executive Summary 2.

in conjunction with, not over the top of' the Accounting Associations to promote auditor independence.[488]

It is important to note that although PP agreed with the proposed changes to the FRC's monitoring functions in the Audit Enhancement Bill, PP had reservations in relation to the composition of the FRC.[489] PP commented that the composition of the FRC is largely comprised of representatives from the Big 4 firms.[490] PP was of the view that there is the potential for any strategic policy advice from the FRC to be influenced by the private interests of the larger accounting firms.[491] PP was concerned that such strategic policy advice could result in regulation that would reduce the number of listed company external auditors from non-Big 4 firms.[492] PP was of the view that as a consequence non-Big 4 firms could lose further market share to the Big 4 firms in an audit market already dominated by the Big 4 firms.[493]

General Statement of Principle requiring Independence

GT supported the general definition of auditor independence however, the code of ethics for professional accountants should have been in the definition adopted in CLERP 9.[494] The Middle Tier Firms were not successful in their lobbying efforts in this regard as the Corporations Act prescribes a general requirement for auditor independence instead of adopting the code of ethics for professional accountants.[495]

Annual Declaration by Auditor

Stockford supported this proposal but suggested that such a declaration should be a professional requirement and not a requirement in the Corporations Act as the

[488] Ibid.
[489] Pitcher Partners, Submission to the Treasury, *Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth)*, 28 October 2011, 5.
[490] Ibid.
[491] Ibid.
[492] Ibid.
[493] Ibid.
[494] Grant Thornton, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 17 November 2003, 4.
[495] Corporations Act s 324CA.

Accounting Associations have historically been associated with the regulation of auditor independence.[496] The Middle Tier Firms were not successful in their lobbying efforts in this regard as the Corporations Act requires a written declaration by the individual auditor, that there have been no contraventions of the auditor independence requirements of the Corporations Act. This is because rather than allowing the declaration to be prescribed solely as a professional requirement (and as consequence having it regulated solely by the respective Accounting Associations), as it is set out in the Corporations Act, it now comes under the jurisdiction of ASIC (in addition to the Accounting Associations).[497]

Employment Relationships

Stockford supported the proposal to review these requirements but was of the view that these requirements should be determined by the AASB[498] and included as part of the professional requirements to be adhered to by members of the Accounting Associations instead of being incorporated into CLERP 9.[499] The Middle Tier Firms were not successful in their lobbying efforts in this regard as the restrictions applying to employment relationships between auditors and audited bodies have been set as legal requirements in CLERP 9.[500]

Financial Relationships

Stockford supported additional obligations on financial relationships but were of the view that the AASB should determine these rules.[501] BDO recommended replacing

[496] Stockford Accounting Services Pty Ltd, above n 483, 13.
[497] Corporations Act s 307C(1).
[498] The AASB is empowered by section 227B of the ASIC Act to develop auditing standards and to provide guidance on auditing and assurance matters.
[499] Stockford Accounting Services Pty Ltd, above n 483, 13.
[500] Corporations Act s 324CI and s 324AE.
[501] Stockford Accounting Services Pty Ltd, above n 483, 13.

the definition of 'immediate family member' to that used overseas that was 'spouse and dependents'.[502]

The Middle Tier Firms were not successful in their lobbying efforts in this regard as the Corporations Act currently introduces additional obligations on financial relationships (not determined by the AASB) and does not replace the definition of 'immediate family member' with that used overseas that was 'spouse and dependents'.[503]

Non-Audit Services

The Joint Submission was of the view that the code of ethics for professional accountants adequately considers all threats to independence and as such this proposal should refer to compliance with this code.[504] Stockford supported this proposal but considered that any amendments to the disclosure requirements should be introduced through existing standards rather than incorporating changes to the legislation.[505]

The Middle Tier Firms were unsuccessful in their lobbying efforts for the regulation of non-audit services to be considered by the Accounting Associations and not to incorporate such changes into legislation.[506] The Corporations Act currently regulates the provision of non-audit services as it requires listed companies to disclose non-audit services that have been provided in the company's annual report including details of the amounts paid or payable to the auditor for non-audit services provided and a statement from the directors stating that the provision of the non-audit services does not compromise the auditor independence requirements of the Corporations Act.[507]

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[502] BDO Chartered Accountants and Advisers, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 28 November 2003, 1.
[503] Corporations Act s 324CE(5) and s 324CH(1).
[504] Pitcher Partners, BDO, William Buck, Grant Thornton, Horwarth Australia, Joint Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework* , 22 November 2002, 11.
[505] Stockford Accounting Services Pty Ltd, above n 483, 14.
[506] Corporations Act s 300(11B).
[507] Ibid.

Auditor Rotation

The Joint Submission, PKF and Stockford expressed their preference for the adoption of the 7 year rotation period as prescribed by the code of ethics for professional accountants. They lobbied against the proposed 5 year rotation period.[508] GT, PKF and PP were of the view that the lead engagement partner was the main person responsible for the conduct of the audit. As a consequence, the lead engagement partner should be the only person to be rotated and that the review partner should be excluded from this requirement.[509]

According to GT, in relation to the conduct of audits concerning SMEs, the review partner's role focused on quality control and in such circumstances the threat to independence (over-familiarity) would be unlikely as the review partner would have no direct communication with the auditee. As a consequence, there is less of a need for the review partner to be rotated.[510] PP concurred with GT's view. PP stated that the rotation of the review partner cannot be justified as a review partner's role was concerned with regulatory compliance in the financial statements and not a review of the actual audit. On this view, contact with the auditee is kept to a minimum and there is no justification for rotating the review partner.[511]

PP did not agree that both the lead engagement and review partner should be rotated after 5 years. According to PP, the lead engagement partner often took up the role of review partner. The review partner's prior audit experience as lead engagement partner with the auditee can be useful in providing 'an appropriate assessment of matters arising from an audit' and can potentially enhance the quality of the audit.[512]

The Joint Submission, BDO and GT were of the view that this proposal was too broad as it applied to every company without having regard to its size. In particular, this

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[508] PP, BDO, William Buck, Grant Thornton, Horwarth Australia, above n 504, 14, PKF Australia Limited, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 22 November 2002, 1 and Stockford Accounting Services Pty Ltd, above n 483, 16.
[509] Grant Thornton, above n 494, 3, PKF Australia Limited, above n 508 and Pitcher Partners, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 13 November 2003, 5.
[510] Grant Thornton, above n 494, 2.
[511] Pitcher Partners, above n 509.
[512] Ibid.

proposal failed to differentiate SMEs.[513] PKF was adamant that this proposal 'would not prevent corporate collapses or prevent individual auditors from acting in an unprofessional manner'.[514] Instead it would reduce the number of audit firms that can service the listed audit market and therefore may inhibit competition in this audit space.[515]

The Middle Tier Firms were initially unsuccessful in their lobbying efforts for an increase from 5 years to 7 years for lead engagement partner and review partner rotation as the earlier amendment to the Corporations Act required that the lead engagement and review partner acting in the capacity of the external auditor for the listed company rotate after 5 years.[516]

With the enactment of the Audit Enhancement Act however, the Middle Tier Firms were generally successful in their lobbying efforts for an increase from 5 years to 7 years for lead engagement partner and review partner rotation as the amended Corporations Act enables the directors to allow the lead engagement or review partner who has acted as an external auditor for the listed company for 5 successive financial years to continue to act in such a capacity for up to a further 2 years provided that the auditor independence requirements are complied with.[517]

Streamline Auditor Discipline Arrangements

PKF and Stockford objected to the proposal for the CALDB members to consist of a majority of non-accountants.[518] It would appear that the Middle Tier Firms were generally successful in their lobbying efforts to prevent a majority of non-accountants being represented on the board of the CALDB as can be seen in the current composition of the CALDB. The ASIC Act has stipulated that the current membership of the CALDB

[513] PP, BDO, William Buck, Grant Thornton, Horwarth Australia, above n 504, 14, BDO Chartered Accountants and Advisers, above n 502, 2 and Grant Thornton, above n 494, 2.
[514] PKF Chartered Accountants & Business Advisers, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 19 November 2002, 3.
[515] Ibid.
[516] Corporations Act s324DA .
[517] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 4 and Audit Enhancement Act Schedule 1 Part 1 item 7.
[518] PKF Australia Limited, above n 508 and Stockford Accounting Services Pty Ltd, above n 483, 20.

comprise of 14 members and that the 6 'accounting members' comprise of representatives from a 'professional accounting body' which could mean either the CPA, the Institute and/or the IPA.[519] This will result in at least 6 members of the CALDB comprising at all times of accountants that have the appropriate skills to evaluate matters which are presented to the CALDB. Members from the Accounting Associations are not excluded from being separately appointed as a business member as long as that person fulfils the requisite criteria as a business member.[520] The composition of the CALDB is therefore not restricted to a majority of non-accountants.

4.2.4 Small Firms

This group consists of Cameron, Wappett & Partners and Harding.

Auditor Rotation

Cameron and Harding lobbied against the specified rotation period as it was perceived to be detrimental to the business of Small Firms.[521] Harding noted that smaller audit firms were given special consideration concerning the rotation of the lead engagement and review partners at the end of 5 years. Harding commented that special consideration would be given for the lead engagement and review partners from smaller audit firms to rotate at the end of 7 years. In Harding's opinion, this concession 'did not address the issues in any way'.[522]

The Small Firms were unsuccessful in their lobbying efforts to prevent the periodic rotation of partners. According to Harding, this special consideration which could potentially extend the partner rotation period of smaller audit firms to 7 years did not resolve the existing issues.[523] Although not specifically stated, it is assumed that these

[519] ASIC Act s 203.
[520] Ibid.
[521] D G Cameron, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 21 November 2002, 2 and Harding & Associates, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 8 March 2004, 1.
[522] Ibid.
[523] Ibid.

issues include the lack of partners to rotate. This would mean that small firms may not have the ability to rotate their respective lead engagement and review partners at the end of 7 years. This would result in small firms losing their clients at the end of 7 years.

4.2.5 Australian Public Policy Committee

This group consists of the Accounting Associations, Big 4 Firms and several representatives from the Middle Tier Firms that together formed the APPC that lobbied in relation to the Expanded FRC and the Auditor Rotation requirements.[524]

Expanded FRC

The APPC supported the proposal to delegate the auditor independence monitoring role of the FRC to ASIC so as to avoid the duplication of this role by both the FRC and ASIC.[525] The APPC was successful in this regard as the FRC is no longer required to monitor the auditor independence requirements. ASIC has now been entrusted with this responsibility pursuant to the Audit Enhancement Act.[526]

Auditor Rotation

The APPC agreed with the proposal to extend the lead engagement and review partner rotation from 5 years to 7 years.[527] The lobbying efforts of the APPC were successful as the Audit Enhancement Act provides for the lead engagement or review partner who has acted as an external auditor for the listed company for 5 successive financial years to continue to act in such a capacity for up to a further 2 years provided that the auditor independence requirements are complied with.[528]

4.3 MANAGERS OF COMPANIES (PRODUCER GROUP)

This section will analyse whether there exists a special interest group consisting of various Australian entities that may have lobbied for the current regime. Managers of

[524] Australian Public Policy Committee, above n 381.
[525] Ibid.
[526] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 39 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[527] Australian Public Policy Committee, above n 381.
[528] CPA Australia, Institute of Chartered Accountants in Australia and the Institute of Public Accountants, above n 428 and Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 4 and Audit Enhancement Act Schedule 1 Part 1 item 7.

Companies (Producer Group) are defined as producers of financial information. As such this category comprises of Australian entities that produce financial information. Factors that may influence their decision to lobby for or against legal reform in relation to auditor independence includes (amongst other things) increase in audit costs as a result of more stringent legislation for auditors (for example, compulsory auditor rotations for listed entities), auditor independence legal reform aimed at curbing or reducing their influence in the audit standard setting process and the creation of additional obligations on entities to disclose more information.

From the analysis of the relevant submissions, it is submitted that there exists various special interest groups consisting of various Australian entities that have lobbied for the current regime. These special interest groups consist of the Australian Chamber of Commerce and Industry ("**ACCI**"), Australian Council of Super Investors Inc ("**ACSI**"), Australian Institute of Company Directors ("**AICD**"), Association of Superannuation Funds of Australia Ltd ("**ASFA**"), Business Council of Australia ("**BCA**"), CSR Ltd ("**CSR**"), Compostela Pty Limited ("**Compostela**"), Group of 100 Inc ("**G100**"), Financial Services Institute of Australasia ("**Finsia**"), Financial Services Council ("**FSC**"), Finance Sector Union of Australia ("**FSU**"), Governance Institute of Australia ("**GI**"), Insurance Australia Group Limited ("**IAG**"), International Banks and Securities Association of Australia ("**IBSA**"), Public Sector & Commonwealth Superannuation Boards ("**PSCSB**"), Public Sector & Commonwealth Superannuation Schemes, the Catholic Super Fund and the Northern Territory Public Authorities Superannuation Scheme ("**PSCSS**"), Trustee Corporations Associations of Australia ("**TCA**") and Telstra Ltd ("**Telstra**").

For the purposes of discussion, the AICD, BCA, Finsia, FSU, G100, GI and the IBSA have been included under this section although these interest groups cannot be strictly defined as producers of financial information. The membership of the AICD consists of individual directors[529] and the BCA comprises of an association of the CEO's of Australia's leading corporations.[530] Finsia is the result of a merger between the Australasian Institute of Banking & Finance and the Securities Institute of Australia and

[529] AICD, *About Us* <http://www.companydirectors.com.au/General/Header/About-Us>.
[530] BCA, *About Us* <http://www.bca.com.au/about-us>.

represents financial services professionals throughout Australia and New Zealand.[531] The FSU is a union that comprises of members from the finance industry[532] and the G100 represents 'Australia's senior finance executives from Australia's major private and public business enterprises'.[533] The GI (formerly known as the Chartered Secretaries Australia Limited) is the professional body that represents practising company secretaries[534] and the IBSA represents the interests of investment banks.[535] As such, these interest groups may not necessarily fully represent the interests of Australian entities.

Entities that are involved in the business of superannuation such as the ACSI, ASFA, FSC (formerly known as the Investment & Financial Services Association Ltd), PSCSB, PSCSS, have also been included under this section. This is because these superannuation entities are themselves producers of financial information and have similar profit seeking objectives as the companies in which they invest in. Both the superannuation entities as well as the companies in which they invest will most likely choose a course of action that can generate the best financial return for their respective shareholders. Likewise, overly prescriptive audit independence regulation that is perceived to be unnecessary and not cost effective will most probably be frowned upon and rejected by both the investor (the superannuation entities) as well as the investee companies. A review of the actual submissions indicates that these superannuation entities have lobbied for the same outcomes as the managers of companies.[536] These findings provide further support that they have similar motivations as the managers of companies and therefore are included in the same category as the managers of companies for the purposes of this thesis.

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[531] Finsia, *About Finsia* <http://www.finsia.com/about_finsia2/corporate/history1>.
[532] FSU, *History of the FSU* <http://www.fsunion.org.au/About-the-FSU/History-of-the-FSU/default.aspx>.
[533] G100, *Home* <http://www.group100.com.au/home.htm>.
[534] GI, *About Us* <http://www.governanceinstitute.com.au/about-us/>.
[535] International Banks and Securities Association of Australia, Submission to the Treasury, *Exposure Draft Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 10 November 2003, 1.
[536] For example, the ASFA suggested that the FRC be entrusted with broad oversight powers in order to enhance auditor independence, see Association of Superannuation Funds of Australia Ltd, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 25 November 2002, 3. This general view was also supported by the ACCI. See, the Australian Chamber of Commerce and Industry, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 28 November 2002, 3.

Entities that are involved in the business of trusts namely, the TCA have also been included under this section. This is because these trust entities are assumed to have the best interests of their beneficiaries in mind and therefore seek to profit in the companies in which they may invest in from time to time. Both the trust entities as well as the companies in which they invest will most likely choose a course of action that can generate the best financial return for their respective beneficiaries. Likewise, overly prescriptive audit independence regulation that is perceived to be unnecessary and not cost effective will most probably be frowned upon and rejected by both the investor (the trust entities) as well as the investee companies. A review of the actual submissions indicates that these trust entities have lobbied for the same outcomes as the managers of companies.[537] These findings provide further support that they have similar motivations as the managers of companies and therefore are included in the same category as the managers of companies for the purposes of this thesis.

Expanded FRC

The ACSI and the ASFA advocated for increased representation on the FRC by superannuation funds.[538] The ASFA stated that in view of the combined holdings of superannuation funds amounting to 'one-third of all shares', the ASFA recommended that these funds have direct representation on the FRC in order 'to ensure the integrity of the oversight of auditors' (such as by supporting measures that promote auditor independence) so as to protect the interests of their respective investors.[539]

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[537] For example, the TCA had supported the Annual Declaration proposal, see Trustee Corporations Association of Australia, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, November 2002, 2. This was also consistent with the recommendations of the FSC, GI and IAG, see Investment & Financial Services Association Ltd, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, (no date), 3, Chartered Secretaries Australia, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 22 November 2002, 2 and Insurance Australia Group, Submission to the Treasury, *Exposure Draft Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 18 November 2003, 4-5.

[538] Australian Council of Super Investors Inc, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 10 November 2003, 3 and Association of Superannuation Funds of Australia Ltd, above n 536.

[539] Association of Superannuation Funds of Australia Ltd, above n 536.

It would appear that the ASFA was successful in its lobbying efforts to maintain its influence on the FRC by securing membership on the FRC as can be seen in the current composition of the FRC. The Treasurer has determined that the current membership of the FRC comprise of 16 members and that the ASFA nominate 1 member.

According to the ACCI, the success of this proposal is dependent upon the FRC being appropriately comprised of members with a broad range of business skills in addition to expertise in accounting and finance.[540] The G100 and Telstra believed that the composition of the FRC should continue to consist of independent and highly regarded individuals that are not perceived to be associated with private interest lobby groups. On this view, individuals concerned with the public interest should also be included in addition to those with the relevant business and professional skills.[541]

It would also appear that the Managers of Companies (Producer Group) were successful in their lobbying efforts to ensure that the membership of the FRC consist of individuals that possess the relevant business and professional skills, as well as individuals that are independent, highly regarded, concerned with the public interest and not perceived to be associated with private interest lobby groups. This is because the ASIC Act supports the appointment of FRC members from nominations put forward by key stakeholder groups, as well as members appointed independently of stakeholder interests.[542]

The TCA, FSC and GI[543] were unsuccessful in the long-term (albeit successful initially) in lobbying for the FRC to have an expanded role which would include the monitoring of the auditor independence requirements as this has been delegated to ASIC pursuant to the enactment of the Audit Enhancement Act.[544] According to the Explanatory Material to the Audit Enhancement Act, this move would 'remove the

[540] The Australian Chamber of Commerce and Industry, above n 536.
[541] Group of 100 Inc, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 29 November 2002, 1 and Telstra, Submission to the Treasury, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 12 November 2003, 3.
[542] ASIC Act s 235A.
[543] Trustee Corporations Association of Australia, above n 537, Investment & Financial Services Association Ltd, above n 537, 2 and Chartered Secretaries Australia, above n 537.
[544] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 39 and Audit Enhancement Act Schedule 2 Part 1 item 5.

duplication between the operational nature of the FRC's previous function and ASIC's audit inspection program'.[545]

General Statement of Principle requiring Independence

The findings are inconclusive as half of the Managers of Companies (Producer Group) (being the AICD and FSC) made recommendations to amend this proposal[546] whilst the other half (namely the Finsia and GI) generally supported this proposal.[547]

The AICD suggested that it would be more suitable for the general statement to require adherence to the professional codes of conduct of the Accounting Associations (for example, the code of ethics for professional accountants) as these codes reflect the latest international standards in relation to audit independence.[548] The FSC recommended adherence to its own guidelines on the definition of independence.[549]

Annual Declaration by Auditor

The TCA, FSC, GI and IAG broadly supported this proposal.[550] The TCA, FSC, GI and IAG were successful in their lobbying efforts in this regard as the Corporations Act requires an auditor to give the company a written declaration that the auditor has not contravened any of the auditor independence requirements of the Corporations Act and any applicable code of professional conduct.[551]

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[545] Ibid.
[546] Australian Institute of Company Directors, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 19 November 2002, 7 and Investment & Financial Services Association Ltd, above n 537.
[547] Securities Institute of Australia, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 22 November 2002, 2 and Chartered Secretaries Australia, above n 537.
[548] Australian Institute of Company Directors, above n 546.
[549] Investment & Financial Services Association Ltd, above n 537.
[550] Trustee Corporations Association of Australia, above n 537, Investment & Financial Services Association Ltd, above n 537, Chartered Secretaries Australia, above n 537 and Insurance Australia Group, above n 537.
[551] Corporations Act s307C(1).

Employment Relationships

The findings are inconclusive as half of the Managers of Companies (Producer Group) (comprising the AICD, CSR and IAG) lobbied against this proposal[552] whereas the other half of the Managers of Companies (Producer Group) (namely the TCA, FSC and GI) provided wide support for this proposal.[553] According to the AICD and CSR, the proposed 4 years exceeded any other developed market overseas and that the definition for professional audit member needed to be revisited in order to 'avoid shrinking the pool of directors and audit firm staff available to companies'.[554] The IAG also objected to the proposed 4 year requirement and indicated a preference for a shorter term.[555]

Financial Relationships

The findings are inconclusive as half of the Managers of Companies (Producer Group) (being the AICD and BCA) lobbied against this proposal[556] whilst the other half (namely the FSC and GI) generally supported this proposal.[557]

The AICD recommended that a better alternative would be for the Corporations Act to refer to the relevant rules regulating financial relationships prescribed by the professional and ethical codes of conduct for accountants.[558] This was also supported by the BCA.[559] In addition, the AICD was of the view that the definition of 'immediate family' should be replaced with 'spouse and dependents' as the proposed words 'immediate family' was too broad in application.[560]

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[552] Australian Institute of Company Directors, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 17 November 2003, 5, CSR Ltd, Submission to the Treasury, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 10 November 2003, 2 and Insurance Australia Group, above n 537, 7.
[553] Trustee Corporations Association of Australia, above n 537, 3, Investment & Financial Services Association Ltd, above n 537 and Chartered Secretaries Australia, above n 537.
[554] Australian Institute of Company Directors, above n 552 and CSR Ltd, above n 552.
[555] Insurance Australia Group, above n 537, 7.
[556] Australian Institute of Company Directors, above n 546 and Business Council of Australia, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 3 December 2002, 4.
[557] Investment & Financial Services Association Ltd, above n 537 and Chartered Secretaries Australia, above n 537.
[558] Australian Institute of Company Directors, above n 546.
[559] Business Council of Australia, above n 556.
[560] Australian Institute of Company Directors, above n 552, 10.

Non-Audit Services

The majority of the Managers of Companies (Producer Group) (comprising the BCA, AICD, ANZ, Compostela, ACSI, Foster's and the FSU) lobbied against this proposal.[561] Less than half of the Managers of Companies (Producer Group) namely the Finsia, FSC, GI, TCA, PSCSB and PSCSS provided general support for this proposal.[562]

The BCA was of the view that the existing accounting standards could be used to accommodate this proposal.[563] The AICD, ANZ and Compostela supported the adoption of the code of ethics for professional accountants.[564] According to Compostela, this would be consistent with 'international best practice'.[565] The ACSI, Foster's and the FSU recommended a more prescriptive approach.[566] According to Foster's, the non-audit services to be prohibited should be identified in the legislation and that disclosure will only be required in circumstances where a specific contravention has occurred.[567]

The majority of the Managers of Companies (Producer Group) were unsuccessful in their lobbying efforts for the regulation of non-audit services to be best dealt with by accounting or auditing standards and/or to prohibit specific areas of non-audit services.

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[561] Business Council of Australia, above n 556, Australian Institute of Company Directors, above n 552, 12, ANZ, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, November 2002, 4, Compostela Pty Limited, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 22 November 2002, 9, Australian Council of Super Investors Inc, above n 538, 5-6, Foster's Group Limited, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 15 November 2002, 2-3 and Finance Sector Union of Australia, Submission to the PJCCFS, *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 17 November 2003, 2.

[562] Securities Institute of Australia, above n 547, Investment & Financial Services Association Ltd, above n 537, 5, Chartered Secretaries Australia, above n 537, Trustee Corporations Association of Australia, above n 537, 3, Public Sector and Commonwealth Superannuation Boards, Submission to the Treasury, *Discussion Paper on Corporate Disclosure: Strengthening the Financial Reporting Framework*, 22 November 2002, 1 and Public Sector and Commonwealth Superannuation Schemes, the Catholic Super Fund and the Northern Territory Public Authorities Superannuation Scheme, Submission to the Treasury, *Exposure Draft Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 10 November 2003, 2.

[563] Business Council of Australia, above n 556.

[564] Australian Institute of Company Directors, above n 552, 12, ANZ, above n 561 and Compostela Pty Limited, above n 561.

[565] Compostela Pty Limited, above n 561.

[566] Australian Council of Super Investors Inc, above n 538, 5-6, Foster's Group Limited, above n 561 and Finance Sector Union of Australia, above n 561.

[567] Foster's Group Limited, above n 561.

The Corporations Act currently sipulates that the directors of a listed company furnish details of non-audit services that have been provided and requires a statement from the directors stating that the provision of the non-audit services does not compromise the auditor independence requirements of the Corporations Act.[568]

Auditor Rotation

The majority of the Managers of Companies (Producer Group) namely the FSC, TCA, PSCSB and PSCSS provided general support for the implementation of the 5 year rotation period.[569] The AICD, Finsia and the GI on the other hand represented the minority view and expressed preference for the 7 year rotation period.[570] The AICD believed that a 7 year rotation was consistent with international norms and that it is preferred 'given the size of Australia's marketplace, costs to companies arising from more frequent compulsory rotation and the lesser ability of smaller auditing firms to satisfy the requirement'.[571]

The majority of the Managers of Companies (Producer Group) were initially successful in their lobbying efforts for a 5 year rotation period for lead engagement partner and review partner as the earlier amendment to the Corporations Act required that the lead engagement and review partner acting in the capacity of the external auditor for the listed company rotate after 5 years.[572]

With the enactment of the Audit Enhancement Act however, the Managers of Companies (Producer Group) were generally unsuccessful in their lobbying efforts for a 5 year rotation period for lead engagement partner and review partner as the amended Corporations Act enables the directors to allow the lead engagement or review partner who has acted as an external auditor for the listed company for 5 successive financial

[568] Corporations Act s 300(11B).
[569] Investment & Financial Services Association Ltd, above n 537, 7, Trustee Corporations Association of Australia, above n 537, 4, Public Sector and Commonwealth Superannuation Boards, above n 562, 2 and Public Sector and Commonwealth Superannuation Schemes, the Catholic Super Fund and the Northern Territory Public Authorities Superannuation Scheme, above n 562.
[570] Australian Institute of Company Directors, above n 546, 9, Securities Institute of Australia, above n 547, 3 and Chartered Secretaries Australia, Submission to the Treasury, *Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth)*, 28 October 2011, 1.
[571] Australian Institute of Company Directors, above n 546, 9.
[572] Corporations Act s324DA .

years to continue to act in such a capacity for up to a further 2 years provided that the auditor independence requirements are complied with.[573]

Auditors' Duties Expanded

The majority of the Managers of Companies (Producer Group) constituting the AICD, IAG, IBSA and G100 lobbied against this proposal[574] whereas less than half of the Managers of Companies (Producer Group) namely the Finsia, FSC and GI provided broad support for this proposal.[575]

The AICD disagreed with this proposal and suggested that the provision should be reworded to state '*fraudulently* influence, coerce, manipulate to mislead' an auditor.[576] According to the AICD, the inclusion of the word 'fraudulently' introduces a new element of fraud that would need to be proven by the alleged officer in question and requires 'a higher standard of proof'.[577]

The AICD was of the view that the proposal would result in the conduct of audits being 'unnecessarily adversarial' and would portray the auditor as the 'enemy'.[578] The AICD stated that this proposal would 'encourage officers and other employees of a company to ensure that anything that could amount to a contravention of the Corporations Act was kept well and truly away from the attention of the auditors, thereby rendering the section less, rather than more, effective for its purpose'.[579] This approach could potentially 'alter the relationship between a company and its officers and the

[573] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 4 and Audit Enhancement Act Schedule 1 Part 1 item 7.
[574] Australian Institute of Company Directors, above n 546, 16, Insurance Australia Group, above n 537, 9, International Banks and Securities Association of Australia, above n 535, 6-7 and Group of 100 Inc, above n 541, 6.
[575] Securities Institute of Australia, above n 547, 7, Investment & Financial Services Association Ltd, above n 537, 16 and Chartered Secretaries Australia, Submission to the Treasury, *Exposure Draft Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth)*, 10 November 2003, 5.
[576] Australian Institute of Company Directors, above n 546, 16.
[577] Ibid.
[578] Australian Institute of Company Directors, above n 552, 41.
[579] Ibid.

auditor, who would correctly be seen as a conscripted informer to ASIC, whatever the circumstances'.[580]

The IAG, IBSA and G100 did not agree with this proposal and commented that the inclusion of the word 'influence' was not acceptable.[581] The G100 was concerned that normal discussions during the conduct of the audit between the auditor and the officer of the company (where a company's view point has been advanced by the officer in response to a query by the auditor) can be potentially viewed as influencing the auditor and therefore would unnecessarily require ASIC notification.[582]

The majority of the Managers of Companies (Producer Group) were unsuccessful in their lobbying efforts in this regard. The auditors' duties have been expanded to include the reporting to ASIC of any attempt 'to unduly influence, coerce, manipulate or mislead' the auditor.[583]

Streamline Auditor Discipline Arrangements

The findings are inconclusive as half of the Managers of Companies (Producer Group) (being the AICD, Compostela and G100) lobbied against this proposal[584] whilst the other half (namely the AFSA, FSC and GI) broadly supported this proposal.[585]

The AICD and Compostela were of the view that a degree of audit expertise was required by members of the CALDB to be able to understand the audit issues brought before the hearings convened by the CALDB.[586] The G100 and Compostela had concerns about the suitability of a CALDB comprised by a majority of non-accountants.[587]

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[580] Ibid.
[581] Insurance Australia Group, above n 537, 9, International Banks and Securities Association of Australia, above n 535, 6-7 and Group of 100 Inc, above n 541, 6.
[582] Group of 100 Inc, above n 541, 6.
[583] Corporations Act s 311.
[584] Australian Institute of Company Directors, above n 546, 16, Compostela Pty Limited, above n 561, 14 and Group of 100 Inc, above n 541, 7.
[585] Association of Superannuation Funds of Australia Ltd, above n 536, 6, Investment & Financial Services Association Ltd, above n 537, 16 and Chartered Secretaries Australia, above n 575, 6.
[586] Australian Institute of Company Directors, above n 546, 16 and Compostela Pty Limited, above n 561, 14.
[587] Group of 100 Inc, above n 541, 7 and Compostela Pty Limited, above n 561, 14.

On the other hand, the AFSA, FSC and GI supported a majority of non-accountants on the CALDB.[588] The AFSA dismissed concerns that 'non-accountants were somehow incapable of assessing whether accountants had failed in their duty as auditors'.[589]

Shareholders and Investors Advisory Council

The majority of the Managers of Companies (Producer Group) constituting the AICD, Compostela and GI lobbied against this proposal[590] whilst less than half of the Managers of Companies (Producer Group) namely the FSC and TCA provided general support for this proposal.[591]

The AICD, Compostela and GI were not convinced that it was necessary to create another entity to consider reforms in relation to disclosure.[592] It would appear that the majority of the Managers of Companies (Producer Group) were not successful in their lobbying efforts in this regard as to the establishment of a Shareholders and Investors Advisory Council which was announced on 21 June 2004.[593] The successful lobbying efforts of the majority of the Managers of Companies (Producer Group) provide support for the subsequent cessation of the Shareholders and Investors Advisory Council.[594]

4.4 GOVERNMENT OFFICIALS

This section will investigate whether the regulators being the Accounting Professional & Ethical Standards Board Limited, ASIC, ASX, Auditing & Assurance Standards Board, Companies Auditors & Liquidators Disciplinary Board, Financial

[588] Association of Superannuation Funds of Australia Ltd, above n 536, 6, Investment & Financial Services Association Ltd, above n 537, 16 and Chartered Secretaries Australia, above n 575, 6.
[589] Association of Superannuation Funds of Australia Ltd, above n 536, 6.
[590] Australian Institute of Company Directors, above n 546, 17, Compostela Pty Limited, above n 561, 15 and Chartered Secretaries Australia, above n 537, 4.
[591] Investment & Financial Services Association Ltd, above n 537, 17 and Trustee Corporations Association of Australia, above n 537, 4.
[592] Australian Institute of Company Directors, above n 546, 17, Compostela Pty Limited, above n 561, 15 and Chartered Secretaries Australia, above n 537, 4.
[593] Treasury, above n 445.
[594] Ibid. Treasury has confirmed that the Shareholders and Investors Advisory Council was established in 2004, to be chaired by the Parliamentary Secretary to the Treasurer. The meetings of the Shareholders and Investors Advisory Council however proved to be unproductive and as such, it ceased to exist shortly after its creation. Treasury, above n 431.

Reporting Council can be categorized as distinct and separate special interest groups that may have been motivated to influence the development of the current regime in order to ensure the maintenance of their respective position of power or privilege within the community. Factors that may influence their decision to lobby for or against legal reform in relation to auditor independence includes (amongst other things) legal reform aimed at curbing or reducing their influence in the audit standard setting process, the creation of additional obligations on the regulator that may increase the risk of legal proceedings being commenced against the regulator by aggrieved persons and any other action which may cause the regulator to have a reduced position of power or privilege within the community.

Expanded FRC

The ASIC was of the view that it should be responsible for enforcement of the auditor independence requirements pursuant to the Corporations Act.[595] Despite the FRC's previous extensive role in ensuring auditor independence prior to the enactment of the Audit Enhancement Act, enforcement of auditor independence requirements was (and still is) the responsibility of either ASIC (where there is an alleged breach of the Corporations Act) or the Accounting Associations (where there is an alleged contravention of the professional code of conduct), rather than of the FRC.[596] It would appear that the ASIC was successful in its lobbying efforts to maintain its influence in the enforcement of auditor independence requirements as ASIC still retains this responsibility.

With the enactment of the Audit Enhancement Act, the FRC's existing monitoring role in relation to the auditor independence requirements has been delegated to ASIC.[597] According to the Explanatory Material to the Audit Enhancement Act, this move would 'remove the duplication between the operational nature of the FRC's previous function

[595] ASIC, above n 349.
[596] du Plessis, McConvill and Bagaric, above n 5, 257.
[597] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 39 and Audit Enhancement Act Schedule 2 Part 1 item 5.

and ASIC's audit inspection program'.[598] As such, it can be argued that ASIC's influence on the direct monitoring of the effectiveness of auditor independence requirements in Australia through ASIC's audit inspection program is further entrenched.

The ASX suggested that it would be desirable for the composition of the FRC to include people with the relevant experience and skill rather than for the FRC to be comprised entirely of nominees put forward to act as representatives for the various entities.[599]

It would also appear that the ASX was successful in its lobbying efforts to ensure that the membership of the FRC consist of individuals that possess the relevant business and professional skills, as well as individuals that are independent, highly regarded, concerned with the public interest and not perceived to be associated with private interest lobby groups. This is because the ASIC Act supports the appointment of FRC members from nominations put forward by key stakeholder groups, as well as members appointed independently of stakeholder interests.[600]

The FRC had lobbied for an expanded role which included the monitoring of the auditor independence requirements.[601] The FRC's lobbying efforts however proved to be unsuccessful as the enactment of the Audit Enhancement Act effectively removed the FRC from this monitoring role and handed it over to ASIC.[602]

General Statement of Principle requiring Independence

The ASX was of the view that the professional and ethical codes of conduct of the Accounting Associations (for example, the code of ethics for professional accountants) provided 'a more flexible and responsive tool for expounding relevant principles and defining the appropriate criteria than could be achieved through legislation'.[603] The ASX was not successful in its lobbying efforts in this regard as the Corporations Act sets out a

[598] Ibid.
[599] ASX, above n 352.
[600] ASIC Act s 235A.
[601] Financial Reporting Council, above n 345.
[602] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 39 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[603] ASX, above n 352, 1-2.

general requirement for auditor independence instead of adopting the measures for independence within the professional code(s) of conduct of the Accounting Associations.[604]

Employment Relationships

The ASX objected to the 4 year 'cooling off' period stipulated for professional audit staff prior to being appointed 'on the boards of ex-clients' as this exceeded the average 2 year requirement in other international markets.[605] The ASX was successful in its lobbying efforts to limit the 'cooling off' period to 2 years[606] instead of the proposed 4 years.

Non-Audit Services

ASIC suggested that the non-audit services to be prohibited should be specific and clearly identified in the legislation. ASIC however has acknowledged that despite this approach, the threats to independence (for example, independence in appearance) cannot be completely eliminated by such measures.[607]

ASIC was unsuccessful in its lobbying efforts for the regulation of non-audit services in this regard as there is no specific and clearly identifiable list of prohibited non-audit services.[608]

Auditor Rotation

Both the Accounting Professional & Ethical Standards Board Limited and the FRC supported the 7 year rotation.[609] The option to extend the rotation period for an additional

[604] Corporations Act s 324CA.
[605] ASX, above n 352.
[606] Corporations Act s 324CI.
[607] ASIC, above n 349, 16.
[608] Corporations Act s 300(11B).
[609] Accounting Professional & Ethical Standards Board Limited, above n 334 and Financial Reporting Council Audit Quality Task Force, above n 345.

2 years from 5 years was encouraged[610] and was seen to be consistent with international standards.[611]

The Accounting Professional & Ethical Standards Board Limited and the FRC were successful in their lobbying efforts in this respect as the Audit Enhancement Act allows for the lead engagement and review partners to continue to act as external auditor for the listed company for a further 2 years at the end of 5 years, provided certain auditor independence safeguards are met.[612]

Auditors' Duties Expanded

Both the ASX and the Auditing & Assurance Standards Board objected to this proposal as it would simply require the auditor to report all potential contraventions to ASIC no matter how trivial.[613] According to the ASX, the Corporations Act 'previously required the auditor to obtain rectification of minor breaches and to make further enquiries'.[614]

The ASX and the Auditing & Assurance Standards Board were unsuccessful in their lobbying efforts in this regard. The auditors' duties have been expanded to include the reporting to ASIC of any attempt 'to unduly influence, coerce, manipulate or mislead' the auditor.[615]

Streamline Auditor Discipline Arrangements

The CALDB objected to the board of the CALDB being constituted by a majority of non-accountants as the concern was that non-accountants may not have the requisite

[610] Accounting Professional & Ethical Standards Board Limited, above n 334.
[611] Financial Reporting Council Audit Quality Task Force, above n 345.
[612] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 4 and Audit Enhancement Act Schedule 1 Part 1 item 7.
[613] ASX, above n 352, 4 and Auditing & Assurance Standards Board, above n 337.
[614] ASX, above n 352, 4.
[615] Corporations Act s 311.

technical skills and experience to evaluate the matters deliberated by the CALDB and to produce good decisions.[616]

It would appear that the CALDB was generally successful in their lobbying efforts to prevent a majority of non-accountants being represented on the board of the CALDB as the composition of the CALDB is not restricted to a majority of non-accountants as prescribed by the ASIC Act.[617]

4.5 SUMMARY

From the analysis of the relevant submissions, it is submitted that the Accounting Associations and Big 4 Firms successfully lobbied to maintain the Accounting Associations' influence in the enforcement of auditor independence requirements despite being unsuccessful in their efforts for the Accounting Associations to monitor auditor independence requirements. ASIC was successful in its lobbying efforts to maintain its influence in the enforcement of auditor independence requirements as ASIC still retains this responsibility. The Accounting Associations, Big 4 Firms, Middle Tier Firms and the APPC have had an influence for the FRC to focus on oversight and not direct monitoring of the auditor independence requirements in Australia. The Accounting Associations, Managers of Companies (Producer Group) and ASX influenced the development of the composition of the memberships of the FRC. The Accounting Associations and the Managers of Companies (Producer Group) were successful in their lobbying efforts in the development of the content for the auditor's independence declaration. The Accounting Associations, Big 4 Firms and ASX have had an influence in narrowing the restrictions applying to employment relationships. The Accounting Associations, Big 4 Firms, Middle Tier Firms, APPC, APESB and the FRC have had an influence in the increase from 5 years to 7 years for audit engagement partner and audit review partner rotation. The Accounting Associations, Big 4 Firms, Middle Tier Firms, Managers of Companies (Producer Group) and the CALDB have had an influence in the development of the composition of the memberships of the CALDB. The Accounting Associations and the

[616] Companies Auditors and Liquidators Disciplinary Board, above n 342.
[617] ASIC Act s 203.

Managers of Companies (Producer Group) were successful in their lobbying efforts as to the cessation of the Shareholders and Investors Advisory Council.

The next stage of this study will discuss the conclusions reached regarding whether the existing requirements in the current regime have developed in a manner consistent with private interest theory. This discussion will include a comparison of the public interest requirement – the ideal measure, as discussed in Chapter 2, against the existing requirements in the current regime.

The next chapter will look at ways of practically improving the auditor independence requirements in circumstances where the law has developed to protect private rather than public interests. Practical solutions consistent with greater independence (the public interest) will be provided.

Chapter 5: FINDINGS FROM ANALYSIS OF INTEREST GROUP LOBBYING EFFORTS AND PROPOSALS FOR LAW REFORM

5.1 INTRODUCTION

This thesis set out earlier on that ideal auditor independence is consistent with practical legal reform aimed at benefiting the public interest. The public interest for the purposes of this thesis is established in Chapter 2 as the economic needs of the primary users of accounting information, both those individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors. This means that practical legal reform consistent with ideal auditor independence should support the economic needs of these primary users of accounting information.

This chapter evaluates whether the successful lobbying efforts of the various interest groups is consistent with ideal auditor independence by analysing whether these benefit the public interest. These are addressed under the subheadings enforcement of auditor independence requirements, expanded FRC, composition of the memberships of the FRC, auditor's independence declaration, employment relationships, auditor rotation, composition of the memberships of the CALDB and establishment of a Shareholders and Investors Advisory Council.

This stage of the study seeks to achieve this by focusing on the 2 facets of independence identified in Chapter 2, being *independence in fact* and *independence in appearance*. Measures aimed at promoting *independence in fact* and/or *independence in appearance* are consistent with ideal auditor independence as these can support the economic needs of the primary users of accounting information.

This chapter analyses whether the successful lobbying efforts of the various interest groups promote *independence in fact* and *independence in appearance*. This chapter discusses how the successful lobbying efforts of the various interest groups have in some circumstances, compromised ideal auditor independence. This chapter discusses why the reduction of auditor independence in these circumstances is not in the public interest.

This stage of the study highlights potential weaknesses in the current regime for possible legal reform. This chapter looks at ways of practically improving the auditor independence requirements by supporting measures that enhance *independence in fact* and *independence in appearance*, with the sole objective of promoting the public interest.

This chapter concludes that the current regime provides in some circumstances, solutions that produce a less than ideal version of auditor independence. These solutions are inconsistent with the concept of ideal auditor independence and cannot be considered to be in the public interest.

5.2 ENFORCEMENT OF AUDITOR INDEPENDENCE REQUIREMENTS

Chapter 4 has established that the Accounting Associations and Big 4 Firms successfully lobbied to maintain the Accounting Associations' influence in the enforcement of auditor independence requirements, despite being unsuccessful in their efforts for the Accounting Associations to monitor auditor independence requirements. ASIC was successful in its lobbying efforts to maintain its influence in the enforcement of auditor independence requirements as ASIC still retains this responsibility.

5.2.1 Ideal auditor independence analysed

Ideal auditor independence means that the Accounting Associations must be independent from the enforcement process. It is difficult for the Accounting Associations to be seen to be impartial in the enforcement process when there is a conflict of interest. This conflict exists when the Accounting Associations have to make a decision that is not in the public interest in order to protect its own interest. In this situation, the appearance of independence is compromised. In order to address this conflict of interest, it is prudent for another entity to be involved in the enforcement process rather than placing this

responsibility on the Accounting Associations. This however would be inconsistent with the emphasis on self-regulation supported by the Accounting Associations.[618] According to a report prepared for the Treasury, an ethical approach to accounting and in particular audit independence that is self-regulated by the Accounting Associations can assist in promoting a client's trust in accountants.[619] The client's trust in accountants can potentially be enhanced when accountants are perceived by the client to have a strict and enforceable self-regulatory framework in place that is aimed at maintaining the highest ethical standards.[620] The findings in the report provide support for the emphasis on self-regulation advocated by the Accounting Associations.

The IFAC Code (the Accounting Associations are IFAC members and therefore are required to comply with the IFAC Code) defines auditor independence in appearance as

> The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional skepticism has been compromised.[621]

In the context of ideal auditor independence, the Accounting Associations must be independent from the enforcement process. The Accounting Associations must be considered independent in appearance by the public, if the audit as an institution is going to be of value. This means avoiding any conduct that may lead a reasonable person to conclude that the Accounting Associations are not impartial. A conflict of interest exists when the Accounting Associations have to make a decision that is not in the public interest in order to protect its own interest. In this situation, the appearance of independence is compromised.

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[618] See generally, CPA Australia, above n 360, 7, Institute of Chartered Accountants in Australia, above n 360, 4 and National Institute of Accountants, above n 358, 6.
[619] Tasman Asia Pacific, Report to the Treasury, *Analysis of market circumstances where industry self-regulation is likely to be most and least effective* (May 2000) 157.
[620] Ibid 159.
[621] International Federation of Accountants, *2013 Handbook of the Code of Ethics for Professional Accountants* (2013) Section 290.6(b).

5.2.2 Self-regulation and the need for an independent entity to be involved in the enforcement process

This section provides an overview of the self-regulatory approach adopted by the Accounting Associations. This mechanism enables the Accounting Associations to keep its respective members in check by administering disciplinary action in circumstances where its respective members have been found to breach the respective codes of the Accounting Associations in relation to (amongst other things) auditor independence. This section however argues that the appearance of independence is compromised as a reasonable person will conclude that the objectivity of the Accounting Associations is impaired in the enforcement process when there is a conflict of interest. This section proposes that it is important for another independent entity (in addition to the self-regulatory approach adopted by the Accounting Associations) to administer disciplinary action for breaches of the auditor independence requirements in the Corporations Act as this can enhance the appearance of independence and promote the public interest.

The FRC report on Auditor Independence noted that the Accounting Associations conducted regular reviews of their members in order to ensure that their members adhered to (amongst other things) the auditor independence requirements in the current regime. According to the report, external auditors of listed companies were reviewed every three years.[622] The FRC report also noted that in addition to the above, the Institute had separately reviewed the Big Four firms. The report mentioned that the IPA only had a few members that audited listed companies.[623] This is because the CPA and the Institute are the two largest accounting associations in Australia and as a consequence, members from these two professional accounting bodies comprise most of the accountants in public practice.[624]

The self-regulatory approach advocated and supported by the Accounting Associations creates a lack of independence in appearance. The self-regulatory approach

[622] FRC, *FRC Report on Auditor Independence 2007-2008* <http://www.frc.gov.au/reports/2007 2008 AAIR/2007 2008 AIR-10.asp> and FRC, *FRC Annual Report 2011-2012 - Chapter 4* <http://www.frc.gov.au/reports/2011_2012/html/frc_ar_2011-12-06.asp>.
[623] FRC, above n 622 and FRC 2012, above n 622.
[624] Tasman Asia Pacific, above n 619, 144 and 158.

is inconsistent with the definition of independence in appearance in the IFAC Code.[625] Despite the efforts of professional accounting bodies to appear objective by providing for the appointment of at least one lay person on their disciplinary bodies,[626] it is still reasonable to conclude that the Accounting Associations cannot be objective in the enforcement process when a conflict of interest exists. It can be argued that the majority of persons presiding over these disciplinary bodies can still comprise of Accounting Association members and therefore these disciplinary bodies cannot be perceived to be completely free of all conflicts of interest in their decision making.[627]

In order to address this conflict of interest, it is prudent for another entity to be involved in the enforcement process rather than placing this responsibility solely on the Accounting Associations. ASIC carries out surveillance, investigation and enforcement of the financial reporting requirements of the Corporations Act, including the enforcement of auditor independence requirements.[628] Having ASIC responsible for the enforcement of the auditor independence requirements in addition to a self-regulatory enforcement process by the Accounting Associations significantly minimises the risk of the Accounting Associations acting in their own interest at the expense of the public. ASIC by ensuring that the public interest is upheld can only seek to gain more influence in the standard setting process.

The enforcement of the auditor independence requirements in the current regime are consistent with ideal auditor independence as there are checks and balances in place to ensure that these are consistent with the public interest. Both the Accounting Associations (through respective codes) and ASIC have the ability to enforce any

[625] International Federation of Accountants, *2013 Handbook of the Code of Ethics for Professional Accountants* (2013) Section 290.6(b). Fogarty has argued against self-regulation by stating that the AICPA peer-review program was conducted by an interest group that was focused more on preserving its image rather than on audit quality. See generally, Timothy Fogarty, 'The Imagery and Reality of Peer Review in the U.S.: Insights from Institutional Theory' (1996) 21 *Accounting, Organizations and Society* 243, 267. Anantharaman's findings suggest that not all peer reviews can be considered objective. How objective is peer review? Evidence from self-regulation of the accounting profession, Divya Anantharaman, <http://ssrn.com/sol3/papers.cfm?abstract_id1015810>.

[626] See Tasman Asia Pacific, above n 619, 156, CPA Australia, *By-Laws* (March 2013) Section 5.4(b)(i), Institute of Chartered Accountants in Australia, *By-Laws* (current) Section 41(b) and Institute of Public Accountants, *By-Laws* (April 2014) Section 7.1.24(5)A.

[627] See Tasman Asia Pacific, above n 619, 156, CPA Australia, *By-Laws* (March 2013) Section 5.4(b)(i), Institute of Chartered Accountants in Australia, *By-Laws* (current) Section 41(b) and Institute of Public Accountants, *By-Laws* (April 2014) Section 7.1.24(5)A.

[628] See generally, ASIC Act Part 3 Division 3 and Corporations Act Part 2M Division 3.

breaches of auditor independence in the Corporations Act. The mechanisms employed concurrently by both the Accounting Associations and ASIC work together to promote the appearance of independence. The Accounting Associations have been concentrating their efforts to enforce breaches of auditor independence in relation to self managed superannuation funds,[629] whilst ASIC has been carrying out auditor inspection and surveillance programs to ensure that all audit firms comply with the auditor independence requirements in the Corporations Act.[630] When combined with the efforts of ASIC to carry out auditor inspection and surveillance programs, the public interest is advanced, as the appearance of independence is promoted by the concurrent comprehensive approach adopted by both the Accounting Associations and ASIC to enforce the auditor independence requirements in the Corporations Act.

The Tasman Asia Pacific report prepared for the Treasury has noted that non-compliance with the professional and ethical codes of conduct of the respective Accounting Associations can lead to disciplinary proceedings by the professional body to which the member belongs. The outcome of these disciplinary proceedings can result in the temporary suspension or permanent removal of the non-compliant auditor from public practice.[631] The Accounting Associations have disciplined members for breaches of their respective codes that have occurred as a result of auditor independence being compromised.[632] These have included disciplinary tribunal decisions where members were reprimanded for failing to comply with the provisions of their respective codes as

[629] For examples of various tribunal decisions, see decisions from CPA Australia, 10 August 2011, 22 June 2011, 26 October 2010, 13 October 2010, 15 July 2010, 10 March 2010 and 3 March 2010 <http://www.cpaaustralia.com.au/about-us/member-conduct-and-discipline/outcome-of-disciplinary-hearings>, from The Institute of Chartered Accountants, 5 April 2011, 9 December 2010 and 23 June 2010 http://www.charteredaccountants.com.au/The-Institute/Member-complaints-and-discipline/Tribunal-decisions and from the National Institute of Accountants, 30 April 2010 <https://www.publicaccountants.org.au/about-us/complaint-investigation-and-member-disciplinary-processes/disciplinary-tribunal-decisions>.

[630] See generally, Australian Securities and Investments Commission, *Report 242: Audit inspection program public report for 2009 - 10* (June 2011).

[631] Tasman Asia Pacific, above n 619, 155.

[632] For examples of various tribunal decisions, see decisions from CPA Australia above n 629, The Institute of Chartered Accountants above n 629 and National Institute of Accountants above n 629.

regards audit independence in relation to the audit of self managed superannuation funds.[633]

5.2.3 ASIC's role as an independent entity which administers auditor surveillance and enforcement

ASIC can promote the public interest by enhancing the appearance of independence. This is because ASIC can fulfil the role as an independent entity that can enforce any breaches of the auditor independence requirements in the Corporations Act. ASIC however, must be seen to be taking proactive steps to fulfil this role.[634] This section analyses ASIC's role in administering these obligations and proposes that ASIC may need to increase the frequency of its enforcement actions in order to fully measure up to its role as an independent entity that can and will protect the public interest.

The ASIC Act and the Corporations Act entrusts ASIC with overseeing the activities of the external auditor which includes auditor independence.[635] It provides ASIC with statutory powers to monitor auditor independence as well as to initiate action against the non-compliant auditor.[636]

A person who intends to be a registered company auditor must apply to ASIC to become registered as an auditor.[637] ASIC's role in the registration of company auditors is to grant the application and register the applicant as an auditor if 3 conditions are satisfied.[638] These conditions relate to education, competency and being a 'fit and proper person'.[639] ASIC has the discretion to refuse the application if any of these 3 conditions

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[633] For examples of various tribunal decisions, see decisions from CPA Australia above n 629, The Institute of Chartered Accountants above n 629 and National Institute of Accountants above n 629.
[634] It is acknowledged however that the government's 2014 budget cuts to ASIC's funding amounting to $120 million over the next five years can potentially impair ASIC's proactive ability to monitor and enforce the auditor independence requirements in the Corporations Act. See Lexi Metherell, 'Budget 2014: ASIC's funding cut in move away from financial sector oversight', *Australian Broadcasting Corporation News* (Sydney), 15 May 2014 <http://www.abc.net.au/news/2014-05-15/budget-2014-funding-cut-to-asic-business-regulation/5453816>.
[635] See generally, Australian Securities and Investments Commission, above n 630, ASIC Act Part 3 Division 3 and Corporations Act Part 2M Division 3.
[636] See generally, Australian Securities and Investments Commission, above n 630, ASIC Act Part 3 Division 3 and Corporations Act Part 2M Division 3.
[637] Corporations Act s 1279.
[638] Ibid s 1280(2).
[639] Ibid.

are not satisfied.[640] Once the applicant is registered as an auditor however, the CALDB has the jurisdiction to cancel or suspend the registration of an auditor on the application of ASIC.[641]

The requirement of competency is fulfilled by (amongst other things) the applicant being a member of one of the Accounting Associations.[642] Non-compliance with the respective rules of the Accounting Associations can lead to disciplinary proceedings by the professional body to which the member belongs. These disciplinary proceedings can include exclusion from membership. New applicants applying to be a registered company auditor are obligated to disclose details of all disciplinary proceedings by the Accounting Associations to ASIC.[643] Such disclosure may have an adverse impact on the competency and 'fit and proper person' requirements of the new applicant.[644] This may cause ASIC to prohibit the applicant from being a registered company auditor.

Existing registered company auditors (through submission of their compulsory annual statements to ASIC) are also obliged to disclose details of all disciplinary proceedings by the Accounting Associations to ASIC.[645] The requirement for such disclosure can be seen to act as a deterrent for existing registered company auditors who may be thinking about not complying with the rules of their respective professional associations. Such disclosure may have an adverse impact on the competency and 'fit and proper person' requirements of the existing registered company auditor. This information can alert ASIC to conduct an investigation which may eventually lead ASIC to apply to the CALDB to cancel or suspend the registration of the auditor by alleging that the auditor has failed to carry out or perform adequately and properly the duties of an auditor.[646]

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[640] Ibid.
[641] Ibid s 1292.
[642] Australian Securities and Investments Commission, *Regulatory Guide 180, Auditor Registration* (September 2012), 34 <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg180-published-28-September-2012.pdf/$file/rg180-published-28-September-2012.pdf >.
[643] Ibid and RG 180.28.
[644] Australian Securities and Investments Commission, above n 642 and RG 180.28.
[645] Australian Securities and Investments Commission, *Form 912A Annual Statement by an Auditor* (January 2011) 4.
[646] Corporations Act s 1292.

5.2.4 Perceived lack of enforcement by ASIC in recent years

A review of ASIC's surveillance programs conducted during the last 5 years (compiled in Appendixes 2, 3 and 4) noted a combined total of 8 contraventions for breaches of the auditor independence requirements in the Corporations Act.[647] No enforcement action by ASIC was noted in relation to any of these contraventions.[648] This provides support for the view that there appears to be a lack of enforcement by ASIC in recent years. ASIC must be perceived by auditors to be actively pursuing enforcement actions for such contraventions. Active enforcement actions by ASIC can act as a reminder to auditors to be more vigilant in complying with their respective auditor independence obligations pursuant to the Corporations Act. The appearance of independence can be strengthened when the public perceives that ASIC is actively pursuing auditors who breach these requirements.

ASIC has provided the FRC with information in relation to actions taken by ASIC against auditors for potential breaches of the auditor independence requirements in the Corporations Act. ASIC's public record of its surveillance program on audit firms within the last 3 years has indicated 2 instances where ASIC has taken action against auditors for potential contraventions of the auditor independence requirements in the Corporations Act. The FRC report noted one matter where a substantial amount of shares were held in the audited body by immediate family members of a small firm audit partner.[649] In another matter, the FRC report noted that a small firm auditor held financial interests in the audited body.[650] According to the FRC report, both these alleged breaches of auditor independence were referred by ASIC to the Commonwealth Director of Public

[647] Australian Securities and Investments Commission, *Report 317: Audit inspection program public report for 2011-12* (December 2012) 17, Australian Securities and Investments Commission, above n 630, 36 and Australian Securities and Investments Commission, *Report 192: Audit inspection program public report for 2008-09* (March 2010), 29.
[648] Australian Securities and Investments Commission, above n 647, Australian Securities and Investments Commission, above n 630, 36 and Australian Securities and Investments Commission, above n 647.
[649] FRC, above n 622 and FRC 2012, above n 622.
[650] FRC, above n 622 and FRC 2012, above n 622.

Prosecutions.[651] The findings appear to indicate a lack of willingness on the part of ASIC to publicly reprimand the alleged offenders.[652]

The CALDB has the power to take such steps as it considers reasonable and appropriate to publicise its decisions and the reasons for its decisions.[653] A review of the decisions and media releases issued by the CALDB since 1 January 2008 indicate only 1 instance where ASIC has taken action against an auditor for a contravention of (amongst others) auditor independence.[654] In this instance, ASIC had referred an auditor to the CALDB for alleged contraventions of auditor independence. The auditor was found by the CALDB to have audited his own work when conducting the external audits of a company. The CALDB consequently ordered that the auditor's registration be cancelled.[655]

The alternative argument that the reason for the lack of enforcement by ASIC in recent years is because there are no contraventions (that all registered company auditors are complying with the current regime) is inconsistent with the fact that contraventions were noted by ASIC during 2008 to 2012.[656] The CALDB's public record of its decisions since 1 January 2008 indicate only 1 instance where ASIC has taken action against an auditor for a contravention of (amongst others) auditor independence.[657] This affirms a lack of willingness on the part of ASIC to reprimand the alleged offender(s).

ASIC was successful in its lobbying efforts to maintain its influence in the enforcement of auditor independence requirements. The effectiveness of the nature and frequency of ASIC's existing enforcement actions should be investigated by the

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[651] FRC, above n 622 and FRC 2012, above n 622.
[652] Another rare example where ASIC has provided public information on action it has taken against an auditor for contravention of the auditor independence requirements occurred more than 5 years ago. This is where charges were brought by ASIC, relating to an auditor of a listed company, Avastra. The offender had acted in the capacity as the auditor of Avastra and also the company secretary for Avastra at the same time. The auditor was fined $1,000 in May, 2005 for contravention of the audit independence provisions. (ASIC, *ASIC Media Release 05-124*) <http://www.asic.gov.au/asic/asic.nsf/byheadline/05-124 Sydney auditor pleads guilty and is fined for breaching auditor independence provisions?openDocument>.
[653] Corporations Act s 1296(1B).
[654] CALDB, *CALDB Decisions* <http://www.caldb.gov.au/CALDB/CALDBWeb.nsf/byheadline/Decisions?opendocument>.
[655] Ibid.
[656] Australian Securities and Investments Commission, above n 647, Australian Securities and Investments Commission, above n 630, 36 and Australian Securities and Investments Commission , above n 647.
[657] CALDB, above n 654.

Treasury. If found to be deficient, the Treasury may need to provide additional funding to ASIC, in order for ASIC to have the resources necessary to increase the frequency of its enforcement actions for breaches of the auditor independence requirements in the Corporations Act.[658]

5.3 EXPANDED FRC

Chapter 4 has established that the Accounting Associations, Big 4 Firms, Middle Tier Firms and the APPC influenced the development of the FRC to focus on oversight and not direct monitoring of the auditor independence requirements in Australia by limiting the FRC's responsibilities to providing strategic policy advice to the Treasurer.[659] It can be argued that were it not for the subsequent delegation of this power to ASIC, this latest amendment to the current requirements would have increased the Accounting Associations' influence in the monitoring of the auditor independence requirements. However, by delegating this power from the FRC to ASIC, this move enables ASIC to further strengthen its influence in the monitoring of auditor independence requirements as ASIC still retains this responsibility.

5.3.1 Ideal auditor independence analysed

Ideal auditor independence means that there must be an independent entity (other than the Accounting Associations) that directly monitors the auditor independence requirements in Australia. It is difficult for the Accounting Associations to be seen to be

[658] The funding cuts to ASIC amounting to $120 million over five years commencing from 2014 have raised concerns over the ability of ASIC to adequately monitor and enforce contraventions of the Corporations Act. See Metherell, above n 634. In particular, these cost reduction measures can potentially impede ASIC's surveillance and enforcement activities in relation to auditor independence. It may be that as in the case of insolvency matters, ASIC has adequate funding to fulfil its statutory responsibilities. See Australian Senate Committee, Parliament of Australia, *Inquiry into the role of liquidators and administrators in Australia* (2010) http://www.aph.gov.au/senate/committee/economics_ctte/liquidators_09/report/report.pdf. This view however would be in sharp contrast to the IMF's comments that ASIC requires more funding in order to properly carry out its role as a corporate regulator. See Lucy Battersby, 'ASIC needs more funding, says IMF', *The Sydney Morning Herald* (Sydney), 23 November 2012 <http://www.smh.com.au/business/asic-needs-more-funding-says-imf-20121122-29suo.html#ixzz36kkph72A>.

[659] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.

impartial as a conflict of interest can exist when the Accounting Associations have to make a decision that is not in the public interest in order to protect its own interest. In this situation, the appearance of independence is compromised. In order to address this conflict of interest, it is prudent for another entity to be involved in the monitoring process rather than placing this responsibility on the Accounting Associations.

With the enactment of the Audit Enhancement Act, the FRC's direct monitoring powers in relation to auditor independence is delegated to ASIC.[660] This move which is envisaged to remove the duplication[661] between the 'operational' nature of the FRC's previous function and ASIC's audit inspection program is consistent with ideal auditor independence.

As discussed above, ASIC is required by the Corporations Act to carry out surveillance, investigation and enforcement of the financial reporting requirements of the Corporations Act, including the monitoring of auditor independence requirements. It is submitted however that having ASIC responsible for the monitoring of the auditor independence requirements in addition to a self monitoring process by the Accounting Associations significantly minimises the risk of the Accounting Associations acting in their own interest at the expense of the public. ASIC by ensuring that the public interest is upheld can only seek to gain more influence in the standard setting process whilst protecting its own interest.

The monitoring of the auditor independence requirements in the Corporations Act by ASIC in the current regime are consistent with ideal auditor independence as there are checks and balances in place to ensure that these are consistent with the public interest.

5.4 COMPOSITION OF THE MEMBERSHIPS OF THE FRC

The Accounting Associations, Managers of Companies (Producer Group) and the regulator (ASX) have had an influence in the development of the composition of the memberships of the FRC. The Treasurer has determined that the current membership of

[660] Ibid.
[661] Ibid.

the FRC comprise of 16 members and that the Accounting Associations (CPA, Institute and IPA), Managers of Companies (Producer Group) (ASFA) and the regulator (ASX) nominate 1 member each.

It would also appear that the Managers of Companies (Producer Group) and the ASX were successful in their lobbying efforts to ensure that the membership of the FRC comprise a combination of people that have the relevant industry experience, that are independent and not only associated with interest groups. This is because the ASIC Act provides (amongst other things) that 'the Minister may appoint a person by specifying an organisation or body that is to choose the person who is appointed.'[662] As such, the ASIC Act supports the appointment of FRC members from key stakeholder groups in addition to those that are appointed independently and are not associated with such groups.

5.4.1 Ideal auditor independence analysed

Ideal auditor independence means that implementation of this proposal must ensure the FRC is appropriately comprised of members with a broad range of business skills in addition to expertise in accounting and finance.[663] In addition, the membership of the FRC should continue to comprise of independent and highly regarded individuals that are not perceived to be associated with private interest lobby groups. Individuals concerned with the public interest should also be included in addition to those with the relevant business and professional skills.[664]

Prior to the enactment of the Audit Enhancement Act, the FRC was responsible for (amongst other things) monitoring the effectiveness of the auditor independence requirements in Australia. The FRC provided the Treasurer with reports and advice about these requirements.[665] With the enactment of the Audit Enhancement Act, the FRC became responsible for providing broad oversight of the process for setting accounting and auditing standards as well as a new function of giving strategic policy advice and reports to the Treasurer and professional accounting bodies concerning the quality of

[662] ASIC Act s 235A.
[663] The Australian Chamber of Commerce and Industry, above n 536.
[664] Group of 100 Inc, above n 541 and Telstra, above n 541.
[665] ASIC Act s 225(1).

audits conducted by Australian auditors.[666] The new law replaced the FRC's existing function of monitoring the effectiveness of auditor independence requirements in Australia. The matters on which advice and reports can be given by the FRC include strategic policy advice in relation to the auditor independence requirements in the Corporations Act, the auditing standards and the codes of professional conduct used by the professional accounting bodies for audit work undertaken by Australian auditors.[667]

The FRC has the ability to promote the public interest by providing recommendations to the Treasurer that encourage auditors to form objective unbiased judgments through adherence to an ethical code of behaviour. This supports independence in fact. The FRC also has the potential to advance the public interest by offering advice to the Treasurer on measures that promote the appearance of independence. These mechanisms can be in the form of appropriately visible and credible monitoring and sanctions that seek to avoid any conduct that may lead a reasonable person to conclude that the auditor is not impartial.

The ASIC Act provides the Treasurer with the discretion to determine the number of appointments on the FRC.[668] The current FRC membership (being 16 members) allows for a broad spectrum of other stakeholders to be appointed on the FRC despite the Selected Interest Groups having a combined total of more than 4 members on the FRC.[669] The ASIC Act also supports the appointment of FRC members from key stakeholder groups in addition to those that are appointed independently and are not associated with such groups.[670] The discretion provided to the Treasurer to determine the number of appointments on the FRC and the support for the appointment of FRC members from key stakeholder groups in addition to those that are appointed independently and are not associated with such groups in the ASIC Act are consistent with ideal auditor

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[666] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[667] Ibid.
[668] ASIC Act s 235A.
[669] FRC, *Members as at 25 January 2014* <http://www.frc.gov.au/about/members.asp>. Three members from the current FRC membership comprise of representatives from each of the Accounting Associations. The other members were nominated by the Commonwealth, Australian Institute of Company Directors, Business Council of Australia, Group of 100, Financial Services Council, ASFA, Australian Prudential Regulation Authority, ASX, ASIC and the New Zealand Minister of Commerce.
[670] ASIC Act s 235A.

independence which is in the public interest. The inclusion of FRC members independent of stakeholder interests reduces the risk that reports and advice from the FRC will benefit particular interest groups at the expense of others. This promotes the appearance of independence. There is a social gain to be distributed for all interest groups to benefit where FRC members are appointed from nominations put forward by key stakeholder groups, as well as independently of stakeholder interests.

For example, the risk that FRC members comprising of representatives from the Accounting Associations will endeavour to influence policies related to auditor independence for their benefit at the expense of others is mitigated. The inclusion of FRC members independent of stakeholder interests is a mechanism which will encourage a reasonable person to conclude that reports and advice from the FRC to the Treasurer in relation to auditor independence will not compromise the auditor's objectivity. This is because the FRC members, independent of stakeholder interests, will strive to ensure that no one particular interest group (for example, the Accounting Associations) will stand to benefit at the expense of others. This is also consistent with the objectives in the explanatory memorandum which are to achieve independent oversight of the profession and to attain this through building on the existing arrangements.[671]

It is important to note however, that the discretion in the ASIC Act provided to the Treasurer on the number of FRC appointments is very wide. The ASIC Act does not provide the Treasurer with a specific number of appointments on the FRC. In fact, there is no specific minimum or maximum number of FRC appointments required at any one time. In addition, the ASIC Act only provides indirect support for the appointment of FRC members from key stakeholder groups in addition to those that are appointed independently and are not associated with such groups as the ASIC Act states (amongst other things) that 'the Minister may appoint a person by specifying an organisation or body that is to choose the person who is appointed.'[672]

There is still a risk that reports and advice from the FRC will benefit particular interest groups (for example, the Selected Interest Groups), at the expense of others in

[671] Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) 24.
[672] ASIC Act s 235A(1).

circumstances where these interest groups are able to influence the decision making process of the FRC. As such, ideal auditor independence can be compromised, in circumstances where any FRC decision in relation to auditor independence has been influenced by these interest groups represented on the FRC. The Selected Interest Groups stand to benefit from the legal reforms in relation to the composition of the FRC membership. This is because these legal reforms do not curb or reduce their influence in the audit standard setting process. These legal reforms instead increase and enhance their influence by providing them with the opportunity to be represented on the FRC. As a result of this risk, these reforms cannot be considered as being consistent with ideal auditor independence.

A more specific and definite outcome can be achieved with a rewording of section 235A of the ASIC Act (with the proposed amendments in italics and bold) as follows:-

Membership of FRC

(1) The membership of the FRC is to comprise of a minimum of 16 members including the Chair and the Deputy Chair of the FRC. The members are to be appointed by the Minister in writing from nominations put forward by key stakeholder groups, as well as independently of stakeholder interests.

Where the member is appointed by the Minister from a nomination by a key stakeholder group, the Minister must appoint that person by specifying the organisation or body that chose the person.

(2) The members hold office on the terms and conditions that are determined by the Minister.

(3) The Minister must appoint one of the members to be Chair of the FRC. The appointment must be in writing. The FRC may appoint one of its members to be Deputy Chair of the FRC.

This proposal requires that the Treasurer appoint FRC members from nominations put forward by key stakeholder groups, as well as independently of stakeholder interests. This proposal provides direct support for such nominations as compared to the indirect support envisaged under the existing requirements as stated above. In addition, by specifying a minimum number of 16 members, these requirements reduce the risk of the representatives from the Selected Interest Groups collaborating and forming a majority voice that can influence future policy direction in relation to auditor independence.

The proposed requirements provide a better practical solution that enhances the public interest by stipulating that the FRC be widely represented. The proposed requirements also mitigate the risk that strategic policy advice from the FRC will be influenced by representatives from the Selected Interest Groups working in collaboration with each other, to the detriment of the public interest. The current requirements are not consistent with ideal auditor independence and are not the best solution from a practical point of view.

5.5 AUDITOR'S INDEPENDENCE DECLARATION

The Accounting Associations and the Managers of Companies (Producer Group) were successful in their lobbying efforts in the development of the content for the auditor's independence declaration. The Corporations Act requires a written declaration by the individual auditor, that to the best of the individual auditor's knowledge and belief, there have been no contraventions of the auditor independence requirements of the Corporations Act and any applicable code of professional conduct in relation to the audit or review and that any contravention is to be set out in the declaration.[673] This requires adherence to the Accounting Associations' applicable code of professional conduct and allows for the issuing of a qualified declaration (both of which were successfully lobbied by the IPA).

[673] Corporations Act s 307C(1).

5.5.1 Ideal auditor independence analysed

It is in the public interest for auditors to adhere to applicable codes of professional conduct. As discussed in Chapter 2, accounting associations use codes of ethics to create expectations of professional behaviour that are aimed at benefiting the public. According to Dellaportas and Davenport, ethical codes of conduct that define the public interest aim 'to benefit the entire or majority population affected by the services provided by members of the accounting profession.'[674]

It is also in the public interest for the Corporations Act to allow for the issuing of a qualified declaration to enable the auditor to provide a declaration as suggested by the IPA 'that states the circumstance of any breach rather than the auditor simply not making a statement, which may require the auditor to step down and cause problems for the audit process'.[675]

This is consistent with the objective in the explanatory memorandum which is to provide assurance to investors of the integrity of financial reports which in turn supports ideal auditor independence.[676]

As such, the requirement for auditors to adhere to applicable codes of professional conduct and the provision for the issuing of a qualified auditor's declaration can both be considered to be consistent with ideal auditor independence.

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[674] Dellaportas & Davenport, above n 31, 1093-1094. The Accounting Associations are all members of the IFAC which at the time CLERP 9 was being enacted, represented 163 member organisations in 120 countries. (Treasury, *Australian Auditor Independence Requirements* <http://www.treasury.gov.au/documents/1184/PDF/Australian Auditor Independence Requirements.pdf>). The Accounting Associations as members of the IFAC are required to ensure that their ethical codes of conduct reflect, as a minimum, the standards in the IFAC Code. The IFAC Code emphasises five fundamental values which are integrity, objectivity, professional competence, due care, confidentiality and professional behavior that provide the foundation for the auditor independence rules adopted by the Accounting Associations. (<http://web.ifac.org/about/member-bodies> and International Federation of Accountants, *2013 Handbook of the Code of Ethics for Professional Accountants* (2013) Sections 100.1 and 100.5). The adoption of the IFAC Code by the Accounting Associations was consistent with the IFAC objective to encourage its members to act in the public interest (Treasury, Australian Auditor Independence Requirements http://www.treasury.gov.au/documents/1184/PDF/Australian Auditor Independence Requirements.pdf and International Federation of Accountants, *2013 Handbook of the Code of Ethics for Professional Accountants* (2013) Section 100.1).

[675] National Institute of Accountants, above n 358 and National Institute of Accountants PJ, above n 358.

[676] Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) 14.

5.6 EMPLOYMENT RELATIONSHIPS

The Accounting Associations, Big 4 Firms and ASX have had an influence in narrowing the restrictions applying to employment relationships. The Corporations Act prohibits a person from becoming an officer of the audited body for 2 years where the person ceases to be a member of an audit firm or director of an audit company and was a professional member of the audit team for the audit.[677] The Corporations Act defines 'professional members of the audit team' as the external auditor that conducts the audit, any person that exercises professional judgment during the audit and any other person capable of directly influencing the audit.[678]

The Accounting Associations, Big 4 Firms and ASX were successful in their lobbying efforts to limit the 'cooling off' period to 2 years[679] instead of the proposed 4 years. These interest groups were also successful in their lobbying efforts in limiting the restrictions to partners and key senior members of the audit team.[680]

5.6.1 Ideal auditor independence analysed

Ideal auditor independence means that the 'cooling off' period be extended for an indefinite period of time instead of the 2 year prohibition in the Corporations Act.[681] This will reduce the number of qualified directors and audit firm staff available to be employed by companies. The current requirements provide a practical solution which attempts to address auditor independence by introducing a specified 'cooling off' period whilst at the same time this solution also takes into consideration the need for accountants to be available to companies after the 'cooling off' period has expired. It would appear that the current requirements although may not be consistent with ideal auditor independence is arguably the next best solution from a practical point of view. According to Deloitte and EY, at the time when the legislation was being drafted, the US

[677] Corporations Act s 324CI.
[678] Ibid s 324AE.
[679] Ibid s 324CI.
[680] Ibid s 324AE.
[681] Ibid s 324CI.

requirement was 1 year and the European requirement was 2 years.[682] PWC was of the view that a time period exceeding 2 years was considered to be unnecessary as these were inconsistent with comparable international markets (other than the US).[683] The AICD suggested that business efficiency is the reason for not wanting to unduly impede employment opportunities for those who want to move from audit firms to companies. The wealth of knowledge that competent external auditors can bring to the company can be a significant factor that can potentially improve the bottom line of the company.[684] In addition, Deloitte was of the view that limiting the cooling off period to 2 years would also not discourage potential students from entering the auditing profession. These students would not pursue auditing as a profession if their movement as auditors was to be unnecessarily restricted for a prolonged period. The talent pool available for companies to recruit the best and brightest graduates from audit firms will be significantly reduced.[685]

Restrictions applying to partners and key senior members of the audit team are consistent with ideal auditor independence as these are the members of the audit team that participate in the conduct of the audit, exercise professional judgment and are in a position to directly influence the audit outcome.

The specified 'cooling off' period and the restrictions applying to partners and key senior members of the audit team are consistent with ideal auditor independence and with the objectives in the explanatory memorandum which are envisaged 'to strike an appropriate balance between promoting auditor independence and not unduly impeding audit professionals joining companies and bringing with them valuable financial expertise'.[686]

[682] Deloitte Touche Tohmatsu, above n 453, 4 and Ernst & Young, above n 453.
[683] PricewaterhouseCoopers, above n 459.
[684] Australian Institute of Company Directors, above n 552, 12.
[685] Deloitte Touche Tohmatsu, above n 453, 4.
[686] Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) 16.

5.7 AUDITOR ROTATION

With the enactment of the Audit Enhancement Act, the Accounting Associations, Big 4 Firms, Middle Tier Firms, APPC, APESB and the FRC have had an influence in the increase from 5 years to 7 years for audit engagement partner and audit review partner rotation. The amended Corporations Act enables the directors to permit the external auditor who had a key role in the audit of a listed company for 5 successive years to continue to have a key role for up to a further 2 years provided requirements are satisfied in relation to the safeguarding of audit quality and auditor independence.[687]

5.7.1 Ideal auditor independence analysed

Ideal auditor independence means that the auditors who have played a significant role in the audit of a listed company should be rotated on a more regular basis than the current requirement of 7 years as stipulated in the amended Corporations Act.[688] Ideally, it can be argued that the audit firm should be rotated yearly. This can enhance the appearance of independence as auditors from a new firm will always be reviewing the work of the previous year's auditors. Increasing the frequency of compulsory auditor rotation however, will inevitably increase audit costs to companies. These additional costs will have a detrimental impact on the profitability of these companies. As a consequence, the decrease/loss in market value of these companies will be ultimately borne by the shareholders of these companies who (amongst others) are the primary users of accounting information which CLERP 9 has sought to protect (as implied in the key CLERP principles).[689]

The current requirements provide a practical solution which attempts to address auditor independence whilst at the same time seeks to avoid imposing additional financial burden on these companies. The stipulated auditor rotation period achieves significant cost savings as compared to compulsory yearly audit firm rotation which results in the

[687] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 4 and Audit Enhancement Act Schedule 1 Part 1 item 7.
[688] Ibid.
[689] As discussed in Chapter 1, individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors are the primary users of accounting information for the purposes of this study.

enhancement of the economic needs of the shareholders of these companies, being (amongst others) the primary users of accounting information. The stipulated auditor rotation period is consistent with internationally accepted standards (including the ethical codes for professional accountants) which have showed a preference for 7 years in jurisdictions other than the US.[690] It considers the smaller Australian market (as compared to the US), the increased costs to companies as a consequence of unnecessary rotation and the resultant loss of business to small audit firms that may not have the capability to rotate partners.[691] It would appear that the current requirements although may not be consistent with ideal auditor independence is arguably the next best solution from a practical point of view.

5.8 COMPOSITION OF THE MEMBERSHIPS OF THE CALDB

The Accounting Associations, Big 4 Firms, Middle Tier Firms, Managers of Companies (Producer Group) and the CALDB have had an influence in the development of the composition of the memberships of the CALDB. It would appear that the Accounting Associations, Big 4 Firms, Middle Tier Firms, Managers of Companies (Producer Group) and the CALDB were generally successful in their lobbying efforts to ensure that the composition of the CALDB is not restricted to a majority of non-accountants. The ASIC Act has stipulated that the current membership of the CALDB comprise of 14 members and that the 6 accounting members comprise of representatives from a professional accounting body which could mean either the CPA, the Institute and/or the IPA.[692] The ASIC Act has also stipulated that the 6 business members comprise of representatives from the business industry (who possess the requisite skills and experience in the specified category(ies)).[693] This means that additional members from the Accounting Associations (from the CPA, the Institute and/or the IPA) can be appointed as a business member as long as that person fulfils the requisite criteria as a business member. Members from the Accounting Associations are not excluded from

[690] Deloitte Touche Tohmatsu, above n 448, 8, KPMG, above n 449, 11 and PricewaterhouseCoopers, above n 462, 5 and CPA Australia, above n 360.
[691] Australian Institute of Company Directors, above n 546, 9.
[692] ASIC Act s 203.
[693] Ibid.

being appointed as a business member. The composition of the CALDB is therefore not restricted to a majority of non-accountants.

5.8.1 Ideal auditor independence analysed

Ideal auditor independence means that the composition of the CALDB consists of at least a majority of non-accountants. This is because by having at least a majority of non-accountants on the CALDB, it is reasonable to conclude that on matters concerning auditor independence, the majority views of non-accountants will always be considered. This way, the appearance of independence can at least be maintained. It is submitted however, that a level of technical knowledge is required to interpret the quality of auditing and compliance with auditing standards in relation to auditor independence. The current requirements which require the composition of the CALDB to consist of at least a majority of accountants are not consistent with ideal auditor independence.

The CALDB is a disciplinary body that conducts hearings to determine whether an auditor has contravened the Corporations Act.[694] The CALDB only hears matters brought by ASIC as it has no jurisdiction to investigate an auditor's conduct.[695] The CALDB has the power to suspend or cancel an auditor's registration[696] and is regarded as carrying out a 'public protective role'.[697] In fulfilling this role it is important that it is and perceived to be independent.

The CALDB has the ability to promote the public interest as the threat of disciplinary proceedings against registered auditors for failure to comply with the Corporations Act provides an incentive for registered auditors to ensure that they maintain the highest professional standards possible in relation to auditor independence. This approach encourages registered auditors to adhere to their respective codes. Registered auditors can be disciplined for breaches of their respective codes where

[694] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters* (January 2011) 3 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters* (June 2012) 3.
[695] Corporations Act s 1292(1).
[696] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters*, (January 2011), 4-5 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters*, (June 2012), 5.
[697] Companies Auditors and Liquidators Disciplinary Board, above n 341.

auditor independence has been compromised. This supports independence in fact. There is a social gain to be distributed for all interest groups to benefit as the threat of disciplinary proceedings against registered auditors for failure to comply with the Corporations Act provides an incentive for registered auditors to ensure that they maintain the highest professional standards possible in relation to auditor independence. This is because adherence by auditors with the highest ethical standards in relation to auditor independence can strengthen the reliability of financial statements that can potentially enhance the financial well-being of all groups.

The CALDB also has the potential to advance the public interest by strengthening the appearance of independence. A reasonable person will conclude that it is difficult for the Accounting Associations to be impartial in the enforcement process when there is a conflict of interest if the Accounting Associations are to be relied on solely to enforce the auditor independence requirements in the Corporations Act. However, when combined with the efforts of ASIC to carry out auditor inspection and surveillance programs and enforcement and the CALDB to enforce the auditor independence requirements for registered auditors in the Corporations Act, the public interest is advanced. The appearance of independence is strengthened by the comprehensive approach adopted by the Accounting Associations, ASIC and the CALDB to enforce the auditor independence requirements in the Corporations Act. This is consistent with ideal auditor independence as the CALDB (in conjunction with ASIC) has the ability to ensure that there are checks and balances in place in order for the CALDB to fulfil its public protective role.

There are 2 types of applications to the CALDB. These comprise either administrative or conduct matters. Generally administrative matters are heard by a panel of 3 people whereas conduct matters are heard by a panel of 5 people.[698]

A 5 person panel is constituted by the Chairperson (or Deputy Chairperson) with 2 accounting members and 2 business members and a 3 person panel is constituted by the Chairperson (or Deputy Chairperson) with 1 accounting member and 1 business

[698] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters*, (January 2011), 2 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters*, (June 2012), 2.

member.[699] Conduct matters concern the more serious matters where an auditor has allegedly contravened the Corporations Act and this can include auditor independence issues. Administration matters on the other hand would include instances where an auditor has allegedly failed to lodge the required documentation as required by the Corporations Act such as an annual statement or to provide the necessary notification that the auditor is no longer an Australian resident.[700]

Ideal auditor independence means that the composition of each panel of the CALDB constituted to conduct the hearing of each application consists of at least a majority of non-accountants. Members from the Accounting Associations are not excluded from being appointed as a business member. Ideal auditor independence is compromised when additional members from the Accounting Associations are appointed as a business member where that person fulfils the requisite criteria as a business member.

The composition of each panel of the CALDB constituted to conduct the hearing of each application should be restricted to a majority of non-accountants. The appearance of independence cannot be maintained as long as the ASIC Act allows members from the Accounting Associations to be accounting members as well as business members.[701] A reasonable person will conclude that it is difficult for a panel comprised of a majority of members from the Accounting Associations to be impartial when deciding on questions that concern auditor independence. This is because these members will (or be seen to) seek to protect the interests of their own respective Accounting Associations first and foremost and as such, the panel's subsequent decision on questions that concern auditor independence cannot be or seem to be impartial.[702] For the panel to be or seem to be

[699] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters*, (January 2011), 5 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters*, (June 2012), 5.
[700] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters*, (January 2011), 2-3 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters*, (June 2012), 2-3.
[701] ASIC Act s 203.
[702] It is acknowledged that members of the Accounting Associations that comprise the CALDB need not necessarily be auditors. Members of the Accounting Associations can include a wide range of other specialisations such as tax accountants, management consultants and insolvency practitioners. It is argued however that these individuals (regardless of their area of specialisation) will seek to protect the interests of their respective Accounting Associations. As set out earlier in Section 4.2, these self-seeking interests can

impartial, the composition of each panel must be restricted to a majority of non-accountants. This approach will encourage a reasonable person to conclude that the decisions of the CALDB are impartial and in the public interest and that the CALDB is fulfilling its public protective role.

The Accounting Associations stand to benefit from the legal reforms in relation to the composition of the CALDB membership. This is because these legal reforms do not curb or reduce their influence in decisions pertaining to auditor independence. These legal reforms instead increase and enhance their influence by providing them with the opportunity to be represented on the CALDB.

A better outcome which will improve the appearance of independence can be achieved by the insertion of a new section 203 (2B) of the Australian Securities and Investments Commission Act as follows:-

> *(2B) A person is not eligible under this subsection for appointment as a business member if the person is a member or has been a member (within the last 5 years prior to the date of the proposed appointment) of:*
>
> *(a) a professional accounting body; or*
>
> *(b) any other body prescribed by the regulations for the purposes of this subparagraph.*

This proposal excludes members from the Accounting Associations and persons who were members of the Accounting Associations within the last 5 years prior to the date of the proposed appointment from being appointed as a business member. This proposal promotes auditor independence by ensuring that the composition of each panel of the CALDB constituted to conduct the hearing of each application is restricted to a

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arise as a consequence of the need for its respective members to be profitable in their business endeavours. For example, the loss of significant audit fees can affect other business units of the same accounting firm in circumstances where the firm is heavily reliant on such audit fees to fund these other business units. The decrease in audit fees can potentially lead to a reduction in the number of tax accountants, management consultants and insolvency practitioners employed by the firm.

majority of non-accountants. In addition, the proposed panel requirement for 2 accounting members to be part of a 5 person panel for conduct matters and for 1 accounting member to be part of a 3 person panel for administrative matters, will have the necessary level of technical knowledge required to interpret the quality of auditing and compliance with auditing standards in relation to auditor independence. This proposal is consistent with ideal auditor independence as the composition of the CALDB is restricted to a majority of non-accountants. At any one time, the CALDB will comprise of 6 accounting members and 8 non-accountants.

The proposed requirements provide a better practical solution which accommodates the technical knowledge requirement whilst at the same time this solution also takes into consideration the need for non-accountants to assess whether accountants have failed in their duty as auditors. The current requirements are not consistent with ideal auditor independence and are not the best solution from a practical point of view.

The CALDB also acts as a disciplinary body to liquidators in addition to auditors.[703] As in the case of auditors, the CALDB also conducts hearings to determine whether a liquidator has adequately fulfilled the duties of a liquidator.[704]

It may be timely to revisit the utility of the CALDB's dual role from the perspective of enhancing auditor independence. It may be necessary to replace the CALDB instead with 2 separate entities, such as a Companies Auditors Disciplinary Board to address solely auditor disciplinary matters and the other a Companies Liquidators Disciplinary Board to deliberate on purely liquidator disciplinary concerns.

This way the members of the Companies Auditors Disciplinary Board can be comprised of a majority of non-accountants as suggested by the recommendations above whilst it may be deemed necessary (for various reasons beyond the scope of this thesis) to enable the Companies Liquidators Disciplinary Board to continue to be comprised as it is.

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[703] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters* (January 2011) 3 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters* (June 2012) 3.

[704] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters* (January 2011) 3 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters* (June 2012) 3.

It may well be that the Companies Liquidators Disciplinary Board ought to continue to be comprised by a majority of accountants as allowed by the existing regulations.[705]

The replacement of the CALDB with 2 distinct entities assuming different responsibilities can potentially improve auditor independence by enhancing the appearance of audit independence and as a consequence, the CALDB's concept of a 'public protective role' can still be achieved.[706]

5.9 ESTABLISHMENT OF A SHAREHOLDERS AND INVESTORS ADVISORY COUNCIL

The Big 4 Firms were successful in their lobbying efforts as to the establishment of a Shareholders and Investors Advisory Council. Treasury has confirmed that the Shareholders and Investors Advisory Council was established in 2004, to be chaired by the Parliamentary Secretary to the Treasurer. The Shareholders and Investors Advisory Council held 2 meetings over 2004 and 2005. However, as the meetings proved to be unproductive, it was agreed by the Parliamentary Secretary to the Treasurer that there should not be further meetings of the Shareholders and Investors Advisory Council. This resulted in the cessation of the Shareholders and Investors Advisory Council. Since then, there has not been any successor body to the Shareholders and Investors Advisory Council that has served in a similar function.[707] It is reasonable to conclude that the Accounting Associations and the Managers of Companies (Producer Group) were successful in lobbying against the existence of the Shareholders and Investors Advisory Council.[708]

[705] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters* (January 2011) 3 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters* (June 2012) 3.
[706] Companies Auditors and Liquidators Disciplinary Board, above n 341.
[707] Treasury, above n 431.
[708] Institute of Chartered Accountants in Australia, above n 360, 22, Australian Institute of Company Directors, above n 546, 17 and Compostela Pty Limited, above n 561, 15.

5.9.1 Ideal auditor independence analysed

The Government's intention to establish a Shareholders and Investors Advisory Council, to be chaired by the Parliamentary Secretary to the Treasurer, which it was to consult on all proposals for legal reform concerning the disclosure of information to ensure these met the needs of retail investors[709] was consistent with ideal auditor independence. The Shareholders and Investors Advisory Council had the ability to promote the public interest as the concept of a shareholder reference group has been considered as a way of ensuring that the concerns of retail investors are appropriately considered in the context of policy issues affecting them. Such a group would act as an external advisory body reporting directly to the government on issues of corporate law and governance affecting shareholders.[710] Where these concerns included matters that relate to auditor independence, the existence of this shareholder reference group provided a convenient forum for these matters to be collated, considered and if required to be acted upon, referred to the Treasurer for further deliberation. The cessation of the Shareholders and Investors Advisory Council is not consistent with ideal auditor independence as retail investors are not being given the opportunity to convey auditor independence concerns.

The successful lobbying efforts of the Accounting Associations and the Managers of Companies (Producer Group) provide support for the subsequent cessation of the Shareholders and Investors Advisory Council.[711] The Accounting Associations and the Managers of Companies (Producer Group) stand to benefit from the cessation of the Shareholders and Investors Advisory Council. This is because the actions of the members from the Accounting Associations and the Managers of Companies (Producer Group) will no longer be open to the scrutiny of a shareholder reference group comprised of (amongst others) retail investors. Retail investors now no longer have the opportunity to investigate disclosure-related concerns that relate to auditor independence in order to ensure that these concerns are consistent with ideal auditor independence.

It was envisaged that the Shareholders and Investors Advisory Council would be requested to consider future proposals to change aspects of the corporate regulatory

[709] Treasury, above n 26.
[710] Ibid.
[711] Institute of Chartered Accountants in Australia, above n 360, 22, Australian Institute of Company Directors, above n 546, 17 and Compostela Pty Limited, above n 561, 15.

framework. The Council would make its comments directly to the Treasurer and where possible the Council would be consulted at an early stage of the policy development process.[712] Policies that did not support independence in fact or in appearance could be identified and reported directly to the government. There was a direct channel of communication for improvements (where applicable) to be promptly recommended.

It is debatable as to whether the Shareholders and Investors Advisory Council, if it existed today would comprise members that would represent the interests of the public. Members were to be appointed by the government and were to include individual retail investors as well as nominees from appropriate retail investor bodies.[713] It is difficult to predict how the government appointed members representing certain groups would seek to promote their respective group interests at the expense of others, without knowing which groups were involved. The exact number of individual retail investors the government would have appointed as members is also debatable.[714] The appearance of independence can be strengthened if the Shareholders and Investors Advisory Council was to comprise of a more diverse membership capable of collectively providing impartial advice to the government on auditor independence.

5.9.2 CAMAC's role as an independent entity that can provide advice and recommendations in relation to auditor independence

There is another body, CAMAC that was set up in 1989 to advise the government independently in relation to matters concerning the corporations law.[715] CAMAC members are appointed on the basis of industry experience and not in a representative

[712] Institute of Chartered Accountants in Australia, above n 360, 22, Australian Institute of Company Directors, above n 546, 17 and Compostela Pty Limited, above n 561, 15.
[713] Institute of Chartered Accountants in Australia, above n 360, 22, Australian Institute of Company Directors, above n 546, 17 and Compostela Pty Limited, above n 561, 15.
[714] The only publicly available information on these past members are the names of the foundation members. Whether these people represented individual retail investors or were nominees from appropriate retail investor bodies cannot be easily verified. The practical difficulty in obtaining information regarding the Shareholders and Investors Advisory Council given the limited time the organisation was in operation was noted from email correspondence with the Treasury. Personal email from Richard Chung (Treasury) to Kelvin Kuan, 3 August 2011.
[715] CAMAC, *About CAMAC* <http://www.camac.gov.au/camac%5Ccamac.nsf/0/7AE520F065F88121CA2572B10081C695?opendocument>.

capacity. Only one ASIC nominee is appointed to provide a 'regulatory perspective'.[716] CAMAC's function is to advise the Treasurer on any changes to the corporations legislation.[717] As such, auditor independence concerns would be well within the purview of CAMAC.

The potential benefits from the continued existence of CAMAC (as an alternative to the Shareholders and Investors Advisory Council) can be considered a social gain to be distributed for all interest groups to benefit. Unlike the Shareholders and Investors Advisory Council, there is no requirement for CAMAC to include individual retail investors as well as nominees from appropriate retail investor bodies as members. There is a social gain to be distributed for all interest groups to benefit. The social gain is the enhancement of the appearance of independence by not having this requirement. It is reasonable to conclude that the absence of nominees from appropriate retail investor bodies eliminates the risk that government appointed members representing certain groups would seek to promote their respective group interests at the expense of others. As such, CAMAC has (and can be seen to have) the ability to provide impartial advice to the government on auditor independence.[718]

Both the Shareholders and Investors Advisory Council and CAMAC should not be relied upon solely to address auditor independence concerns. This is because both of them serve in advisory capacities to the government. They are not able to control the outcome of their respective recommendations. At best, even if their recommendations are taken on board, the process of approving the relevant legislation and adoption by the respective entities will be time consuming. Any legislation created as a result will also

[716] ASIC Act s 147.

[717] Pursuant to s 148 of the ASIC Act, CAMAC can on its own initiative or when requested by the Treasurer, advise and provide recommendations about any matter connected with the corporations law which includes auditor independence.

[718] It is acknowledged however that despite the perceived benefits that CAMAC can contribute to enhancing auditor independence, a review of its published reports since 1999 have not revealed any instance where deliberations and/or proposals were made in relation to auditor independence. See Corporations & Markets Advisory Committee, Australia, *Reports & Related Papers of CAMAC* <http://www.camac.gov.au/camac/camac.nsf/o/3DD84175EFBAD69CCA256B6C007FD4E8?opendocument>. Subsequent to the submission date of this thesis, CAMAC has been abolished due to cost reduction measures introduced by the government in mid-2014. See Georgia Wilkins, 'Abolishing of Corporations and Markets Advisory Committee', *The Sydney Morning Herald* (Sydney), 14 June 2014 <http://www.smh.com.au/business/abolishing-of-corporations-and-markets-advisory-committee-20140613-3a2uc.html>. As such, CAMAC can no longer be considered a viable mechanism by which auditor independence can be promoted.

have a broad application and may not have a retrospective effect. A large number of entities may be required to comply with the latest requirements. There is no remedy that can be acted upon expeditiously. Despite best intentions, the Shareholders and Investors Advisory Council and CAMAC are not able to rectify the problem at the source efficiently before it becomes a problem.

At the other extreme is the argument that government intervention is not necessary. This passive alternative allows for the capital market to self correct. This means that investors will penalize or reward an entity based on the price investors are willing to pay for shares in the entity. For example, in the case of a listed entity, its share price will reflect the various degrees of auditor independence that investors are willing to accept and pay for. This alternative is not in the public interest as it does not protect investors from suffering financial loss. In these circumstances, any decrease in share price as a result of any auditor independence concern, will cause investors to suffer financial loss.

5.9.3 The role of the Shareholders and Investors Advisory Council

The Shareholders and Investors Advisory Council could provide another channel of communication (other than ASIC), where retail shareholders could raise their specific auditor independence concerns. This role would not take the place of ASIC as regulator but could potentially facilitate the reporting of shareholder concerns to ASIC. Specific auditor independence concerns raised through this channel of communication could provide ASIC with valuable information. This information would have the potential to enhance ASIC's ongoing audit firm inspection and auditor surveillance programs.

The Shareholders and Investors Advisory Council could be a suitable forum for existing and/or potential investors to convey their concerns regarding potential breaches of the Corporations Act which could include specific questions relating to auditor independence. Investor concerns could be considered by the Shareholders and Investors Advisory Council in a more expeditious manner (as compared to CAMAC). This is because the objective of the Shareholders and Investors Advisory Council would be to

promote and protect the interests of retail investors.[719] The Shareholders and Investors Advisory Council would be more motivated to ensure that any accounting irregularities as a result of (amongst other things) auditor independence concerns be addressed as soon as possible as the outcome of such an investigation would have a direct financial impact on retail investors. These concerns could potentially be reported by the Shareholders and Investors Advisory Council to ASIC sooner rather than later. Earlier detection of the accounting irregularities by ASIC could prevent further financial loss to retail investors.

The Shareholders and Investors Advisory Council could also act as an external advisory body reporting directly to the government on (amongst other things) general auditor independence concerns.[720] These concerns could involve proposals which pertain to the formulation of new corporate law. These concerns would extend beyond the scope of ASIC's jurisdiction as ASIC's powers are limited to the application of the existing corporations law. The Shareholders and Investors Advisory Council, as a shareholder reference group, could represent the views of retail investors for proposals to change aspects of the corporate regulatory framework. The Shareholders and Investors Advisory Council would not replace CAMAC as an advisory body to the government but could work in conjunction with and complement CAMAC's role. Proposals for (amongst other things) auditor independence law reform can be provided to the government for consideration on behalf of retail investors. Where in the opinion of the Treasurer, such proposals are considered to be in the public interest, the Treasurer can then refer this matter to CAMAC for independent advice. Where possible, the Shareholders and Investors Advisory Council would be consulted at an early stage of the policy development process. There will be no duplication of roles, as the Shareholders and Investors Advisory Council can be seen to represent the views of retail investors whilst CAMAC can be seen to provide independent and impartial advice to the government. This mechanism has the potential to enhance the appearance of independence as the views of retail investors can be represented by the Shareholders and Investors Advisory Council. The subsequent enactment of auditor independence law reforms as a result of

[719] Treasury, above n 26.
[720] Ibid.

this process can be said to have considered the views of retail investors through this shareholder reference group.

It is difficult to predict how successful this initiative would have been if the Shareholders and Investors Advisory Council were to exist today. Further investigation by Treasury would be required to assess the economic benefits of such an initiative. A highly regarded Shareholders and Investors Advisory Council that represents retail investors can enhance the appearance of independence. In order for this to occur, a reasonable person must be able to conclude that the Shareholders and Investors Advisory Council will represent and promote the interests of retail investors in relation to auditor independence law reform.

The Shareholders and Investors Advisory Council was considered to be unproductive in the past.[721] This resulted in its subsequent demise.[722] If the concept of this shareholder reference group is to be mooted again, measures need to be taken to ensure that the new Shareholders and Investors Advisory Council can enhance the appearance of independence. Careful consideration will need to be made in the selection of its advisory committee members so that it can be perceived by the public to represent the views of retail investors. The advisory committee members will also need to have the requisite skill, knowledge and experience, to be able to present these views in a timely manner, for consideration by ASIC or the government, as the case may be, depending on whether these concern the application of the existing corporations law or the formulation of new corporations law. The government will also have to provide the necessary funding for the Shareholders and Investors Advisory Council to operate effectively. These recommendations are not intended to be exhaustive but instead are general comments on how the new Shareholders and Investors Advisory Council should be established in order to be considered productive and therefore avoid the same fate as the earlier government initiative.

The Shareholders and Investors Advisory Council was potentially a suitable and convenient platform to facilitate discussions with a view to addressing any concerns in an

[721] Treasury, above n 431.
[722] Ibid.

efficient and timely manner. A practical solution that provides retail investors with the opportunity to convey auditor independence concerns needs to be formulated. Amendments to the current regime for audit committees have the potential to support this objective.

5.10 AUDIT COMMITTEE

According to Bradbury, the audit committee can enhance the credibility of financial statements by promoting audit independence.[723] Commentators have claimed that audit committees can achieve this objective through providing a means by which the various structures of an entity, being the board of directors, internal auditors, external auditors and audit committee can communicate on audit independence matters.[724]

Lama is of the view that an independent audit committee can assist in causing the decision making process of management to be more transparent. This is because the decisions of management can be scrutinized by the audit committee and as a result, management can be held accountable for their actions. This way selfish decisions by management can be discouraged whilst at the same time, the existence of an independent audit committee can give rise to the perception (from the investing public's perspective) that such entities are more likely to scrutinize the actions of management and to make management accountable for their actions.[725]

Audit committees have been advocated by some commentators to be an effective deterrent to fraud in financial reporting. According to McMullen, listed entities in the United States that had audit committees were 'associated with a reduced incidence of errors, irregularities and other indicators of unreliable financial reporting.'[726] Likewise

[723] Michael Bradbury, 'The Incentives for Voluntary Audit Committee Formation' (1990) *Journal of Accounting and Public Policy* 19, 21.
[724] Blue Ribbon Committee, *Report and Recommendations of Blue Ribbon Committee on Improving the Corporate Audit Committee* (1999) 30-31.
[725] Mandatory Audit Committees in Australia: Are There Economic Justifications? Tek Lama, <http://ssrn.com/sol3/papers.cfm?abstract_id1721315>.
[726] Dorothy McMullen, 'Audit Committee Performance: An Investigation of the Consequences Associated with Audit Committees' (1996) 15(1) *A Journal of Practice and Theory* 87, 96.

commentators such as Dechow, Sloan and Sweeny[727] and Defond and Jiambalvo[728] have found that firms with audit committees were less likely to manipulate earnings.

Notwithstanding the above, various other findings also support arguments that the mere existence of an audit committee does not necessarily improve the quality of financial reporting. Beasley found that the existence of an audit committee did not significantly act as a deterrent to fraudulent financial reporting.[729] Lama also concluded that firms with an audit committee were not necessarily 'better able to manage risk and utilize the firms' resources more effectively than those without audit committees.'[730] Bradbury examined the motivations behind voluntary audit committees for listed entities in New Zealand and suggested that 'audit committees are often created for the purposes of appearances rather than to enhance stockholders' control of management.'[731] Bradbury alluded to audit committees as having high perceived worth[732] in the United States, where they provide a method for delaying the introduction of new legislation and appeasing the mass media.[733]

Despite the inconclusive research findings which support the benefits for the existence of the audit committee, it is submitted that until such time when it is proven otherwise, the audit committee has the potential to enhance shareholder value even if it means that it is created for the purposes of appearances rather than to enhance stockholders' control of management. The existence of a properly constituted and functioning audit committee can enhance the appearance of independence, as the audit committee's role is to (amongst others) ensure the independence of its external auditors. It is for this reason that the creation of the audit committee is advocated in this study.

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[727] Patricia Dechow, Richard Sloan and Amy Sweeney, 'Causes and Consequences of Earning Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC' (1996) 13(1) *Contemporary Accounting Research* 1, 31.
[728] Mark DeFond and James Jiambalvo, 'Incidence and Circumstances of Accounting Errors' (1991) 66(3) *The Accounting Review* 643, 653.
[729] Mark Beasley, 'An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud' (1996) 71(4) *The Accounting Review* 443, 463.
[730] Lama, above n 725.
[731] Bradbury, above n 723, 25.
[732] Ibid 24.
[733] Ibid 33.

The audit committee is a suitable forum which has the potential to enhance auditor independence. This is because the ASX already has in place listing requirements which require certain listed entities to have audit committees and best practice recommendations in relation to audit committees for other listed entities to aspire to achieve. The ASX requires that an entity included in the S&P All Ordinaries Index at the beginning of its financial year have an audit committee during that year.[734] If an entity is included in the S&P / ASX 300 Index at the beginning of its financial year, it must follow the recommendations in Principle 4 of the ASX Corporate Governance Principles on the composition, operation and responsibilities of the audit committee.[735]

The existing Recommendation 4.2 requires that the audit committee be structured so that it consists only of non-executive directors, consists of a majority of independent directors, is chaired by an independent chair (who is not chair of the board) and has at least 3 members.[736] The commentary under the subheading 'Technical expertise' states:

> That the audit committee should include members who are all financially literate (that is, be able to read and understand financial statements); at least 1 member should have relevant qualifications and experience (that is, should be a qualified accountant or other finance professional with experience of financial and accounting matters); and some members should have an understanding of the industry in which the entity operates.[737]

The commentary under the subheading 'Responsibilities' states:

> That the audit committee should review the integrity of the company's financial reporting and oversee the independence of the external auditors.[738]

A better solution that enhances auditor independence can be achieved by amendments to the commentary under the subheading 'Technical expertise' (with the proposed amendments in italics and bold) as follows:-

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[734] ASX Listing Rule 12.7.
[735] Ibid.
[736] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations with 2010 Amendments* (2nd ed, 2010) 26.
[737] Ibid 27.
[738] Ibid.

The audit committee should comprise members who are qualified accountants and have an understanding of the industry in which the entity operates.

A better solution that provides retail investors with the opportunity to convey auditor independence concerns can be achieved by amendments to the commentary under the subheading 'Responsibilities' (with the proposed amendments in italics and bold) as follows:-

The audit committee should review the integrity of the company's financial reporting and oversee the independence of the external auditors. ***This will include addressing any auditor independence concerns conveyed by retail investors. The company must endeavour to ensure that all shareholders (regardless of the number of shareholdings) are made aware that a shareholder can convey any auditor independence concern in relation to the company, directly to the audit committee***.

Where there is no audit committee, the board of directors should review the integrity of the company's financial reporting and oversee the independence of the external auditors. This will include addressing any auditor independence concerns conveyed by retail investors. The company must endeavour to ensure that all shareholders (regardless of the number of shareholdings) are made aware that a shareholder can convey any auditor independence concern in relation to the company, directly to the board of directors.

5.11 A CHECKLIST TO ASSIST WITH THE EVALUATION AS TO WHETHER A LEGISLATIVE PROPOSAL IS CONSISTENT WITH THE PUBLIC INTEREST

There is a need for a comprehensive checklist to be compiled by the Treasury in order for the government of the day to refer to when evaluating whether new legislative proposals are in the public interest in relation to proposals concerning auditor independence. This checklist should include an analysis of the various interest groups that stand to gain (or lose) from such proposals.

This would not only assist in making the lobbying process more transparent but could also enhance the public interest by making the government of the day more accountable for its actions. The checklist can include the cost benefit analysis provided by the Treasury for each new proposal. In addition, the Treasury can also be requested to extend its findings to include a cost benefit analysis for each of the various interest groups that stand to gain (or lose) from the implementation of such proposals as well.

Where possible, estimates of the financial impact of such proposals could be provided by the Treasury to provide supporting evidence for the gain (or loss) to each of the interest groups being analysed. It is acknowledged that Treasury already includes estimates of the financial impact of such proposals in a broad way. However, the additional inclusion of specific estimates of the gain (or loss) to each of the relevant lobby groups would provide a clearer picture to the public of the financial impact of these proposals.[739]

The appearance of independence can be potentially enhanced when legal proposals (in relation to audit independence) consistent with the public interest are seen to be adopted. In circumstances where legal proposals may not be entirely in the public interest but are introduced into law anyway, audit independence can still be promoted where reasonable explanations are provided by the Treasury to the public in a timely manner.

[739] A sample checklist has been included in Appendix 5 for reference.

5.12 SUMMARY

From the findings above, the Selected Interest Groups may have had a significant impact in the development of the current regime. The members of accounting professional bodies (in particular, the Accounting Associations, Big 4 Firms and Middle Tier Firms, APPC), managers of companies (ASFA) and government officials (APESB, ASIC, ASX, CALDB, FRC) lobbied successfully for various proposals.

The findings from this study support the proposal of the thesis that there is a case for reform of the existing requirements in the current regime in respect of auditor independence because some provisions have developed to serve private rather than the stated goal of the public interest. Based on the submissions examined, lobbying by the Selected Interest Groups in some instances has the ability to influence the outcome of the CLERP 9 Policy Paper. This has resulted in some circumstances, a less than ideal version of auditor independence.

Certain aspects of the current regime discussed above, reflect the interests of the most powerful groups being the Selected Interest Groups. The current regime however, is not only the outcome of intense lobbying among various interest groups but also a moderated final outcome in order for the appearance of social gain to be distributed. This is consistent with Hirshleifer's view that it is generally in the political interest of the government to ensure that some benefits go to all interest groups involved, if there is a social gain to be distributed. Similarly, the government will tend to assure that burdens are spread among all parties, if a social loss has been incurred.[740]

Sections 5.4, 5.8 and 5.9 in this thesis described instances where the proposals in the CLERP 9 Policy Paper would cause some to gain and others to lose certain benefits and in these circumstances, the government will 'lean against the wind' so as to moderate the final outcome. The successful lobbying by the Selected Interest Groups (in relation to the composition of the FRC and the CALDB), the successful lobbying by the ASFA (in relation to the composition of the FRC) and the successful lobbying by the Accounting Associations and the Managers of Companies (Producer Group) (in relation to the cessation of the Shareholders and Investors Advisory Council), are instances where

[740] Hirshleifer, above n 295.

adoption or non-adoption (as the case may be) of the respective proposals have benefited these interest groups at the expense of greater auditor independence (the public interest). The government has in these circumstances, endeavoured to ensure that some portion of the social gain goes to all interest groups as well.

The inclusion of FRC members independent of stakeholder interests promotes the appearance of independence as it appears to reduce the risk that reports and advice from the FRC will benefit particular interest groups at the expense of others. Where FRC members are appointed from nominations put forward by key stakeholder groups, as well as independently of stakeholder interests, there is a social gain to be distributed for all interest groups to benefit, as the FRC can be seen to have the ability to provide impartial advice to the government on auditor independence.

The threat of disciplinary proceedings by the CALDB against registered auditors for failure to comply with the auditor independence requirements in the Corporations Act supports independence in fact. This threat of disciplinary action by the CALDB provides an incentive for registered auditors to ensure that they maintain the highest professional standards possible. This has the ability to promote the public interest and as such, is a social gain to be distributed for all interest groups to benefit.

The absence of nominees from appropriate retail investor bodies from CAMAC eliminates the risk that government appointed members representing certain groups would seek to promote their respective group interests at the expense of others. There is a social gain for all interest groups to benefit as the appearance of independence is enhanced as CAMAC can be seen to have the ability to provide impartial advice to the government on auditor independence.

This less than ideal version of auditor independence reflected in the current regime is the government's practical solution to ensure that all parties benefit from the new legislation. It may be questioned whether this solution represents the public interest or private interests. This practical solution cannot and should not be considered as the ideal solution. This is because the submissions analysed above indicate that some interest groups (being the Selected Interest Groups) stand to benefit more by the introduction of the various proposals successfully lobbied by them. As such, it can be argued that the

introduction of the various proposals successfully lobbied by these respective interest groups may not necessarily be in the best interests of the public and may even be at the expense of the public.

Sections 5.4.1, 5.8.1, 5.9.3, 5.10 and 5.11 presented improvements that should be made to the current regime in relation to the composition of the memberships of the FRC, CALDB, the establishment of a new Shareholders and Investors Advisory Council, the role of the audit committee and a recommendation for the Treasury to adopt a suitable checklist in order to enhance the appearance of independence. These are introduced through a combination of self and mandatory regulation.

The discretion in the ASIC Act provided to the Treasurer on the number of FRC appointments is very wide. In addition, the ASIC Act only provides indirect support for the appointment of FRC members from key stakeholder groups in addition to those that are appointed independently and are not associated with such groups.[741] The ASIC Act needs to be amended by specifically providing for a minimum number of 16 FRC members and for the Treasurer to appoint FRC members from nominations put forward by key stakeholder groups, as well as independently of stakeholder interests.

The appearance of independence on the CALDB cannot be maintained as long as the ASIC Act allows members from the Accounting Associations to be accounting members as well as business members.[742] Members from the Accounting Associations and persons who were members of the Accounting Associations within the last 5 years prior to the date of the proposed appointment must be excluded from being appointed as a business member. This proposal promotes auditor independence by ensuring that the composition of each panel of the CALDB constituted to conduct the hearing of each application is restricted to a majority of non-accountants.

A new Shareholders and Investors Advisory Council could potentially facilitate the reporting of specific auditor independence concerns by retail shareholders to ASIC. ASIC's ongoing audit firm inspection and auditor surveillance programs could potentially be enhanced by this information. The appearance of independence can be promoted as the

[741] ASIC Act s 235A(1).
[742] Ibid s 203.

views of retail investors can be seen to be represented by this shareholder reference group.

A new Shareholders and Investors Advisory Council could also act as an external advisory body reporting directly to the government on proposals in relation to general auditor independence concerns which pertain to the formulation of new corporations law. The Shareholders and Investors Advisory Council could complement any future consultative mechanism to be created by the government (acting in a similar capacity to CAMAC) as an advisory body to the government. The appearance of independence can be strengthened as the subsequent enactment of auditor independence law reforms as a result of this process can be said to have considered the views of retail investors through this shareholder reference group.

The audit committee should comprise of members who are qualified accountants and have an understanding of the industry in which the entity operates. The larger ASX listed companies must endeavour to ensure that all shareholders (regardless of the number of shareholdings) are made aware that a shareholder can convey any auditor independence concern in relation to the company, directly to the audit committee at first instance and where there is no audit committee, to the board of directors. It is envisaged that this will address any auditor independence concerns conveyed by retail investors in addition to the proposed creation of a new Shareholders and Investors Advisory Council as set out above.

It is recommended in Section 5.11 that the Treasury utilise an appropriate checklist in order to ensure that legislative proposals concerning audit independence are consistent with the public interest and to provide reasons in circumstances where this objective cannot be entirely achieved. Its findings should also be made publicly available. The appearance of independence can be promoted as the general public will be able to have a better understanding of the cost and benefit to each interest group that may seek to influence the development of audit independence legislation.

It is envisaged that the implementation of all of the proposals mentioned above can potentially improve audit independence. This is because these proposals promote the appearance of independence. Achieving this objective can be considered to be in the

economic interests of the primary users of accounting information and therefore is consistent with promoting the public interest.

Chapter 6: CONCLUSION

6.1 INTRODUCTION

Commentators have suggested that the fundamental role of the external auditor is to provide an independent attestation of a corporation's financial statements.[743] An independent audit process does not have the capability on its own to prevent corporate collapses but it has the potential to enhance the credibility and integrity of financial reporting.

It has been established earlier in this thesis that independence is a critical component to the auditing process as the independence of the external auditor can enhance the credibility of a corporation's financial statements. Without the independence of the external auditor, the credibility of a corporation's financial statements can be questioned as these statements would generally comprise representations from management.[744] This is consistent with Briloff's view that the financial reports of an entity would be perceived by the investing public to have no value without the independence of the external auditor, as the financial reports of an entity cannot be relied upon to give a true and fair view of the entity's financial position.[745]

Commentators have proposed that the corporate collapses of multi-million dollar companies provided the impetus for policy makers to examine the corporate governance systems which existed at that time.[746] Examples of these corporate collapses include Enron and WorldCom in the United States[747] and HIH and One.Tel in Australia[748] in early 2000. The resultant public outcry caused the respective governments to move swiftly to introduce legal reforms to auditor independence that were perceived by these

[743] du Plessis, McConvill and Bagaric, above n 5, 243 and Ladakis, above n 5.
[744] Mautz and Sharaf, above n 19.
[745] Briloff, above n 21.
[746] De Martinis, above n 2, du Plessis, McConvill and Bagaric, above n 5, 243 and Ladakis, above n 5.
[747] De Martinis, above n 2, du Plessis, McConvill and Bagaric, above n 5, 243 and Ladakis, above n 5.
[748] De Martinis, above n 2, du Plessis, McConvill and Bagaric, above n 5, 243 and Ladakis, above n 5.

policy makers to remedy the problems that contributed to the collapse of those entities in their respective jurisdictions.[749]

According to these commentators, CLERP 9 was the Australian policy makers' perceived legislative solution to remedy the deficiencies in auditor independence in Australia.[750] The rationale for CLERP can be determined from the six 'key principles' provided by the Treasury in a discussion paper titled, CLERP – Policy Framework.[751] The emphasis on market integrity, reasonable access to information for all investors, the confidence of individual investors in the fairness and integrity of financial markets, the provision of necessary investor and consumer protection and the consistent and fair application of regulation to encourage high standards of business practice and ethics, are themes in these 'key principles' that consistently aim to safeguard the public interest.

CLERP 9 introduced auditor independence requirements which comprised of (amongst others) a general requirement that prohibits the auditor from auditing the auditee where a conflict of interest situation exists[752] and specific auditor independence requirements which included stipulated auditor declarations[753], regulated employment[754] and financial relationships[755], provided requirements for disclosure of non-audit services[756], auditor rotation rules[757] and prescribed auditor notifications[758]. The Financial Reporting Council was also entrusted with the task of providing strategic policy advice to the government in relation to the auditor independence requirements in the Corporations Act.[759]

The reliability of a corporation's financial statements can be enhanced in circumstances where legal measures are designed to promote ideal auditor independence.

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[749] De Martinis, above n 2, du Plessis, McConvill and Bagaric, above n 5, 243 and Ladakis, above n 5.
[750] De Martinis, above n 2, see generally, Ramsay, above n 3, du Plessis, McConvill and Bagaric, above n 5, 243 and Ladakis, above n 5.
[751] Treasury, above n 6.
[752] Corporations Act s324CA-324CC.
[753] Ibid s307C(1).
[754] Ibid s324CI.
[755] Ibid s324CH(1).
[756] Ibid s300(11B).
[757] Ibid s324DA.
[758] Ibid s311.
[759] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.

Legal reform that seeks to promote ideal auditor independence is consistent with the public interest, can be considered as advancing the public interest and as such, is in the public interest.[760]

The use of private interest theory to evaluate the development of CLERP 9 has indicated that in some circumstances, the public interest objective has not been achieved. The research findings from this study support the proposal of the research project that there is a case for reform of the existing requirements in the current regime in respect of auditor independence as some provisions are currently structured to serve private rather than the stated goal of the public interest. This thesis evaluated how the current legislation was established as a result of lobbying efforts on the part of specific interest groups rather than by consideration of the public interest. This study proposed practical solutions and alternatives to the existing corporate governance framework to improve the existing requirements for it to be consistent with greater independence (the public interest).[761]

This chapter draws conclusions from the research findings and explains how these findings can be applied to legal reform. In addition, the findings also support the use of private interest theory as an alternative method by which legal proposals in relation to auditor independence can be evaluated.

6.2 THE RESEARCH FINDINGS

This thesis demonstrated that ideal independence means that the external auditor must be free from all conflicts of interest, actual and/or perceived. Ideal independence from the perspective of 'operational independence' (for the reasons provided in Section 2.4.4) is impossible to achieve under current institutional arrangements. It is acknowledged that there exists a nexus between the audit client as the auditor's

[760] This is consistent with the accountants' ethical code of conduct to serve the public interest which appears in Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2013) Section 100.1.

[761] The public interest is the rationale (or one of the main considerations) for new legislation to be introduced as can be inferred from each of the six key CLERP principles as discussed in Chapter 2. Chapter 5 identifies circumstances in which the public interest can be promoted and introduces various proposals that seek to support greater independence on the part of auditors.

paymaster and the auditor within current institutional arrangements which can potentially impair auditor independence. As long as external auditors are still being remunerated for the audit services they provide by the very same companies they audit, ideal auditor independence is impossible to attain. Despite this however, there is still scope for legal reform that can potentially enhance ideal auditor independence within existing arrangements in areas where this ideal is found to be inadequate without abolishing this nexus between the audit client as the auditor's paymaster and the auditor.

In addition, this thesis has explained that the current practice of auditing significantly relies on the auditee's management for information. This practice reduces the need for the auditor to obtain the relevant information on many instances directly from its source in order to keep audit costs at an acceptable level. Notwithstanding this, legal reforms that are consistent with ideal auditor independence can still be proposed within the existing arrangements without the need to change the practice of auditing.

The various facets of independence were outlined, namely organizational independence and operational independence. The former can be further segregated into *independence in fact* and *independence in appearance* and the latter, into *informational independence* and *epistemic independence*. This thesis evaluated the existing requirements with a view to providing proposals which support ideal auditor independence in the area of organizational independence in circumstances where ideal auditor independence was found to be lacking. This meant that practical measures that could potentially enhance *independence in fact* and *independence in appearance* were considered for the purposes of this thesis in the evaluation of the existing requirements and the development of proposals for legal reform.

In order to address ideal auditor independence inadequacies in the current regime, the public interest requirement was first established. This is because auditor independence legal reform had to be developed with the objective of benefitting clearly identified individuals and focused on efforts to support specific interests. The established definition of the public interest assisted in the evaluation of whether these clearly identified individual interests had been promoted in the current regime.

This thesis critically evaluated the meaning of 'the public interest' using the framework developed by Cochran.[762] It provided a definition of 'the public interest' in order to establish a measure to assess the adequacy of the current regime. Chapter 2 used this framework to answer 2 questions (1) who exactly is the public and (2) what are the interests of the public.

In order to determine who exactly is the public, reference was made to the code of ethics which defined the 'public' as 'the collective well-being of the community of people and institutions that the members serve'.[763] The key CLERP principles limit the scope of this broad definition of the 'public' to primary users of accounting information. As explained in Section 2.2, the objectives identified in the key CLERP principles (objectives that provided support for market integrity, reasonable access to information for all investors, the confidence of individual investors in the fairness and integrity of financial markets, the provision of necessary investor and consumer protection and the consistent and fair application of regulation to encourage high standards of business practice and ethics) consistently aimed to safeguard the primary users of accounting information. In doing so, it can be implied that this broad definition of the 'public' was intended to comprise a relatively large number of people but not the whole community. The code of ethics described these users of accounting information as 'investors, the business and financial community, and others who rely on the objectivity and integrity of members to maintain the orderly functioning of commerce'.[764] The focus of any legal reform will be concerned with the primary users of accounting information, namely individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors. This is the definition of the 'public' which has been adopted for the purposes of this thesis.

In order to determine what are the interests of the public, reference was made to the key CLERP principles to elaborate on the meaning of the 'collective well-being'. The key CLERP principles that aim to safeguard the primary users of accounting information as

[762] Cochran, above n 31, 329.
[763] The definition of the public interest can be found in the now superseded Accounting Professional & Ethical Standards Board Limited, *Code of Ethics for Professional Accountants APES 110* (2006) Section 100.1.1.
[764] Ibid.

discussed above, were also consistent with safeguarding the economic interests of the primary users of accounting information. Support for this is also provided for in the Second Reading Speech of the CLERP 9 Bill which stated that CLERP 9 was designed 'to modernise business regulation and foster a strong and vibrant economy, progressing the principles of market freedom, investor protection and quality disclosure of relevant information to the market.'[765] This indicates that the development of CLERP 9 was strongly influenced by economic objectives for law reform with emphasis on safeguarding the economic interests of the primary users of accounting information. Therefore, this implies that interests are concerned with the economic needs of the primary users of accounting information. This is the definition of 'interests' which has been adopted for the purposes of this thesis.

This thesis established that ideal independence (practical measures that could potentially enhance *independence in fact* and *independence in appearance*) can be promoted where auditor independence legal reform is aimed at benefiting the public interest. Such legal reforms should support the economic needs of the primary users of accounting information, the individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors.

Private interest theory was adopted to evaluate how the current regime emerged as it takes into consideration the special interest that the Selected Interest Groups have in seeking to influence the regulation of financial reporting. This thesis examined the adequacy of the auditor independence requirements in the Corporations Act and found that in some circumstances, the current regime was designed to serve private interests at the expense of the public interest. This was shown to be not consistent with the public interest rationale for the current regime as can be inferred from the six key CLERP principles.

The findings from this thesis indicate that some provisions in the current regime can be attributed to (amongst other things) the lobbying efforts of particular interest groups. Had it not been for the lobbying efforts of these interest groups, the development

[765] Costello, above n 104.

of these provisions is likely to have resulted in a different outcome. These proposals could have been developed to achieve outcomes that would have better served the economic needs of the primary users of accounting information consistent with the original intentions and objectives of CLERP, rather than the private interests of the various interest groups. The members of accounting professional bodies (in particular, the Accounting Associations, Big 4 Firms and Middle Tier Firms, APPC), managers of companies (ASFA) and government officials (APESB, ASIC, ASX, CALDB, FRC) lobbied successfully for various proposals.

6.3 SUCCESSFUL LOBBYING IN SOME INSTANCES HAVE RESULTED IN PRACTICAL LEGAL REFORM

The successful lobbying efforts of the Selected Interest Groups resulted in practical legal reform that is consistent with the public interest in some instances. The legal reforms that promoted the public interest (which is consistent with ideal independence) were identified as the enforcement of the auditor independence requirements in the current regime by both the Accounting Associations and ASIC, the requirements for auditors to adhere to applicable codes of professional conduct and for the issuing of a qualified declaration and the restrictions applying to partners and key senior members of the audit team.

A conflict of interest can exist if the Accounting Associations are to be relied on solely to enforce the auditor independence requirements in the Corporations Act. The mechanisms employed by ASIC[766] in addition to the measures utilised by the Accounting Associations[767] to enforce such breaches can be perceived by a reasonable person as an independent check on the impartiality of the Accounting Associations. Such efforts were concluded as enhancing the appearance of independence, are consistent with ideal auditor independence and are in the public interest.

[766] See generally, Australian Securities and Investments Commission, above n 630.
[767] For examples of tribunal decisions, see decisions from CPA Australia above n 629, The Institute of Chartered Accountants above n 629 and National Institute of Accountants above n 629.

Likewise, the requirements for auditors to adhere to applicable codes of professional conduct that are based on a universal standard[768] which aim to benefit the collective well-being of the community is in the public interest. This is because Accounting Associations use codes of ethics to create expectations of professional behaviour that are aimed at benefiting the public.[769]

The provision for the issue of a qualified declaration in the Corporations Act which allows the auditor to provide a declaration that states the circumstance of any breach rather than the auditor simply not making a statement is in the public interest. As suggested by the IPA, the prevention of the auditor from making such a qualified declaration can potentially cause the auditor to resign and as a consequence complicate the audit process.[770] This is also consistent with the objective in the explanatory memorandum which is to provide assurance to investors of the integrity of financial reports which in turn supports ideal auditor independence.[771]

The members of the audit team that are in a position to directly influence the audit outcome are those members that participate in the conduct of the audit and exercise professional judgment regarding accounting standards and legal requirements. These are generally partners and key senior members of the audit team. As such, restrictions applying to partners and key senior members of the audit team are consistent with ideal auditor independence. In addition, these restrictions are also consistent with the

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[768] The Accounting Associations are all members of the IFAC which at the time CLERP 9 was being enacted, represented 163 member organisations in 120 countries. (Treasury, *Australian Auditor Independence Requirements* <http://www.treasury.gov.au/documents/1184/PDF/Australian Auditor Independence Requirements.pdf>). The Accounting Associations as members of the IFAC are required to ensure that their ethical codes of conduct reflect, as a minimum, the standards in the IFAC Code. The IFAC Code emphasises five fundamental values which are integrity, objectivity, professional competence, due care, confidentiality and professional behavior that provide the foundation for the auditor independence rules adopted by the Accounting Associations. (<http://web.ifac.org/about/member-bodies> and International Federation of Accountants, *2013 Handbook of the Code of Ethics for Professional Accountants* (2013) Sections 100.1 and 100.5). The adoption of the IFAC Code by the Accounting Associations was consistent with the IFAC objective to encourage its members to act in the public interest (Treasury, Australian Auditor Independence Requirements http://www.treasury.gov.au/documents/1184/PDF/Australian Auditor Independence Requirements.pdf and International Federation of Accountants, *2013 Handbook of the Code of Ethics for Professional Accountants* (2013) Section 100.1).

[769] Dellaportas & Davenport, above n 31, 1093-1094.

[770] National Institute of Accountants, above n 358 and National Institute of Accountants PJ, above n 358.

[771] Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) 14.

objectives in the explanatory memorandum which are 'envisaged to strike an appropriate balance between promoting auditor independence and not unduly impeding audit professionals joining companies and bringing with them valuable financial expertise'.[772]

6.4 SUCCESSFUL LOBBYING IN OTHER INSTANCES HAVE RESULTED IN LEGAL REFORM THAT IS NOT CONSISTENT WITH IDEAL AUDITOR INDEPENDENCE

As discussed in Chapter 5, some of the other legal reforms do not go far enough to promote the economic needs of the primary users of accounting information and these relate to the composition of the memberships of the FRC and the CALDB and to the subsequent cessation of the Shareholders and Investors Advisory Council.

As the FRC is responsible for (amongst other things) providing broad oversight of the process for setting accounting and auditing standards as well as a new function of giving strategic policy advice and reports to the Treasurer and professional accounting bodies concerning the quality of audits conducted by Australian auditors,[773] the appearance of independence can potentially be enhanced where a reasonable person would conclude that the FRC's objectivity has not been compromised. Ideal auditor independence means that the membership of the FRC should comprise a combination of people that have the relevant industry experience, are independent, are concerned with the public interest and not only associated with interest groups. The discretion in the ASIC Act provided to the Treasurer on the number of FRC appointments is very wide as it does not provide the Treasurer with a specific minimum or maximum number of FRC appointments required at any one time. It also does not provide for a specific number of FRC members to be appointed by key stakeholder groups and for FRC members to be appointed independently of stakeholder interests.[774] Mechanisms need to be in place in the legislation to provide for a specific number of FRC members to be appointed by key stakeholder groups as well as for FRC members to be appointed independently of stakeholder interests.

[772] Ibid 16.
[773] Explanatory Material, Corporations Legislation Amendment (Audit Enhancement) Bill 2011 (Cth) 8 and Audit Enhancement Act Schedule 2 Part 1 item 5.
[774] ASIC Act s 235A(1).

Likewise, the appearance of independence can be strengthened where the composition of each panel of the CALDB constituted to conduct the hearing of each application consists of at least a majority of non-accountants. The CALDB conducts disciplinary hearings to determine (amongst other things) whether an auditor has contravened the auditor independence requirements of the Corporations Act.[775] It is important that each panel of the CALDB is and be seen to be independent.[776] Currently, each panel of the CALDB can potentially be comprised of a majority of accountants.[777] This is because members from the Accounting Associations are not excluded from being appointed as a business member. The appearance of independence cannot be maintained as a reasonable person will conclude that it is difficult for a panel comprised of a majority of members from the Accounting Associations to be impartial when deciding on questions that concern auditor independence. In order for the CALDB to fulfil its public protective role, measures need to be in place to ensure that each panel of the CALDB constituted to conduct the hearing of each application consists of at least a majority of non-accountants.

The establishment of a Shareholders and Investors Advisory Council was consistent with ideal auditor independence as this shareholder reference group provided a convenient forum for retail investors to report directly to the government on issues of corporate law and governance affecting shareholders (including concerns that relate to auditor independence).[778] The successful lobbying efforts of the Accounting Associations and the Managers of Companies (Producer Group) provide support for the subsequent cessation of the Shareholders and Investors Advisory Council.[779] The Accounting Associations and the Managers of Companies (Producer Group) stand to benefit from the cessation of the Shareholders and Investors Advisory Council as the actions of the members from the Accounting Associations and the Managers of Companies (Producer

[775] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters*, (January 2011) and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters*, (June 2012).
[776] Corporations Act s 1292(1).
[777] Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Administrative Matters*, (January 2011), 5 and Companies Auditors and Liquidators Disciplinary Board, *Manual of Practice and Procedure Conduct Matters*, (June 2012), 5.
[778] Treasury, above n 26.
[779] Institute of Chartered Accountants in Australia, above n 360, 22, Australian Institute of Company Directors, above n 546, 17 and Compostela Pty Limited, above n 561, 15.

Group) will no longer be open to the scrutiny of a shareholder reference group comprised of (amongst others) retail investors. Retail investors now no longer have this opportunity to investigate disclosure-related concerns that relate to auditor independence in order to ensure that these concerns are consistent with ideal auditor independence.

As such, there is scope for law reform in order for the public interest to be served better. This thesis has looked at ways of improving the auditor independence requirements by providing practical solutions consistent with greater independence (the public interest) where the current regime is not consistent with the public interest. These proposals which promote greater auditor independence, do not have the capability on their own to prevent corporate collapses but rather have the potential to enhance the credibility and integrity of financial reporting consistent with the public interest.

6.5 RECOMMENDATIONS

Proposals for legal reform were developed with the objective of promoting auditor independence and these were set out in Chapter 5. These recommendations are as follows:-

Recommendation 1 – A diverse FRC

In order to promote a more widely represented FRC, specific amendments to the ASIC Act could ensure that FRC appointments independent of stakeholder interests would need to be considered. In addition, as the ASIC Act is silent on the minimum number of FRC members, the risk that the Selected Interest Groups may collaborate and form a majority voice can be reduced by stipulating in the ASIC Act that the FRC comprise a minimum of 16 members.

Recommendation 2 – A majority of non-accountants on the CALDB

The composition of the CALDB should be restricted to a majority of non-accountants so as to improve the appearance of independence. The insertion of a new section in the ASIC Act that specifically excludes members from the Accounting Associations and persons who were members of the Accounting Associations within the

last 5 years from being appointed (as a business member) on the CALDB will ensure that at any one time, the CALDB will comprise of 6 accounting members and 8 non-accountants (a majority of non-accountants).

As Recommendation 2 would be easier to implement than Recommendation 3 (minor amendments to the existing CALDB structure rather than replacing the CALDB outright with 2 different entities), Recommendation 2 should be implemented first as an alternative to Recommendation 3.

Recommendation 3 – 2 new boards, a Companies Auditors Disciplinary Board and a Companies Liquidators Disciplinary Board to replace the existing CALDB

Consideration should also be given for the CALDB to be replaced by 2 distinct and independent entities such as a Companies Auditors Disciplinary Board to address solely auditor disciplinary matters and the other a Companies Liquidators Disciplinary Board to deliberate on purely liquidator disciplinary concerns. This way, 1 single entity need not have to assume the dual responsibility for deciding on both auditor and liquidator disciplinary matters.

Recommendation 4 – A new Shareholders and Investors Advisory Council

The Shareholders and Investors Advisory Council should be reinstated. This is because it is another useful mechanism by which the auditor independence concerns of retail investors can be considered. The government can be promptly informed of issues pertaining to auditor independence by this direct channel of communication and therefore seek to address such concerns expeditiously.

Recommendation 5 – Amendments to the ASX Corporate Governance Principles

The board of directors and the audit committees (where constituted) of listed entities are existing governance structures that can be utilised to enhance the appearance of independence. The proposed amendments to Principle 4 of the ASX Corporate

Governance Principles encourage the board of directors and the audit committees (where constituted) of listed entities to pay attention to the views of any shareholder (regardless of the number of shareholdings) in relation to auditor independence matters of the respective listed entity. In addition, the proposed changes to the existing Recommendation 4.2 of the ASX Corporate Governance Principles promote auditor independence as the amended recommendation seeks to appoint audit committee members that have the requisite qualifications and expertise to deliberate on auditor independence matters.

Recommendation 6 – Adherence by the Treasury to a checklist that promotes auditor independence

The Treasury should prepare and utilise a suitable checklist to ensure that future legislative proposals to be developed with auditor independence in mind are consistent with the public interest. Where this objective cannot be met in its entirety, adequate reasons should be disseminated by the Treasury to the public in a timely manner. It is envisaged that by making this information publicly available, the appearance of independence can be enhanced.

It would be prudent for the government to introduce these proposals in a systematic and sustained manner in order for the anticipated benefits to be fully realised. This way, further improvements consistent with the public interest can be identified from time to time and incorporated in a timely manner.

These proposals can be implemented one at a time. There is no requirement for them to be introduced simultaneously. Recommendation 2 should be trialled for a specific period of time and its effectiveness evaluated before Recommendation 3 is considered.

6.6 HOW THE RESEARCH FINDINGS CAN BE APPLIED TO NEW PROPOSALS FOR LEGAL REFORM

The recommendations stated in the previous section are envisaged to be practical mechanisms by which the appearance of auditor independence can be promoted. The findings from this thesis are also consistent with private interest theory in that powerful interest groups can and will seek to influence the development of corporate law (in particular, auditor independence) in Australia. These findings however can also be applied to the development of future legislation. New legislative proposals can also be similarly examined by applying private interest theory.

As discussed in Chapter 3, the private interest theory of regulation assumes that groups will form to protect particular economic interests. Different groups are viewed as often being in conflict with each other and the different groups will lobby government to put in place legislation that economically benefits them (at the expense of others).[780] The regulatory outcomes reflect the interests of the most powerful group(s).[781]

This thesis analysed the lobbying process of the Selected Interest Groups over a specific period of time. It investigated the lobbying process of the Selected Interest Groups from the time when CLERP 9 was being deliberated until the introduction of the Audit Enhancement Act. The conclusions reached provide supporting evidence that the lobbying efforts of the Selected Interest Groups have (in some instances) influenced the final legislated outcome.

As such, amendments to the current regime will also be subject to similar pressures from the various interest groups that seek to influence the final outcome. The challenge for the government of the day is always to ensure that the public interest can still be upheld, despite the much anticipated lobbying by influential and powerful group(s). This would mean that reforms must be consistent with the original intentions and objectives of CLERP, rather than the private interests of the various lobbying groups.

In upholding the public interest, the government needs to ensure that the legislated outcome does not result in a less than ideal version of auditor independence. This less

[780] Craig Deegan, *Financial Accounting Theory* (McGraw Hill Book Co., 1st ed, 2001) 66.
[781] Peltzman, above n 29, 6-7.

than ideal version of auditor independence can be observed in the composition of the memberships of the FRC and the CALDB and the cessation of the Shareholders and Investors Advisory Council, as reflected in the current regime. This is the government's solution which results in all parties benefiting from the new legislation that compromised ideal auditor independence in the circumstances as discussed in Chapter 5. This moderated final outcome in order for the appearance of social gain to be distributed is inconsistent with the concept of ideal auditor independence and cannot be considered to be in the public interest.

The successful lobbying by the Selected Interest Groups (in relation to the composition of the FRC and the CALDB), the successful lobbying by the ASFA (in relation to the composition of the FRC) and the successful lobbying by the Accounting Associations and the Managers of Companies (Producer Group) (in relation to the subsequent cessation of the Shareholders and Investors Advisory Council), are instances where adoption or non-adoption (as the case may be) of the respective proposals have benefited these interest groups at the expense of greater auditor independence (the public interest). The government however, has not adopted all of their respective proposals, assuring that some portion of the social gain goes to the public as well.

In view of these findings, new legislative proposals need to be carefully examined to ensure that these are consistent with the interests of the primary users of accounting information, being the individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors. These proposals need to be adequately scrutinized to ensure that these do not promote the self-serving interests of the most influential groups that stand to benefit more by the introduction of the various proposals successfully lobbied by them.

6.7 THE WAY FORWARD

The findings from this study support the proposal of this research project that there is a case for reform of the existing requirements in the current regime in respect of independence. This is because in some instances, these have been structured to serve

private interests rather than the public interest. These have benefited the Selected Interest Groups at the expense of greater auditor independence (the public interest).

Not everyone however, will be enthusiastic about embracing further legal reforms. Some commentators have surveyed the views of members of the audit committee and have found that these people would be less enthusiastic to embrace further legislative auditor independence reforms as those surveyed 'do not view further legislative intervention as warranted or necessary.'[782]

The proposed legal reform should be trialed for a specific period of time. This could be over a period of two years or perhaps even longer if more time is required by the Treasury to evaluate the benefits of such proposals. If the change involves significant financial or other costs, the new system may need to be revisited, as the proposed benefit of greater auditor independence may not be justified.

It is envisaged that the lobbying efforts of the various interest groups will continue, as and when new proposals for legal reform arise. This thesis only analyses the lobbying process for CLERP 9 and the Audit Enhancement Act. From the discussions in Chapter 4, it was evident that the Treasury was keen to consult with various stakeholders on the proposals for legal reform. Whether legal reforms in the future would be in the public interest, would need to be investigated further and be the subject of another analysis and discussion.

ASIC has stated that it will continue to monitor and examine the causes of recent corporate collapses. Where deficiencies (for example, the lack of auditor independence) in auditor conduct appear to have contributed to insufficient transparency in the financial position and financial performance of an entity leading up to the collapse, ASIC will focus on these areas in future audit inspections.[783] As such, auditor independence has been and will continue to be an important ongoing consideration. Auditor independence

[782] Albie Brooks, et al, 'Auditor independence reforms: Audit committee members' views' (2005) 23(3) *Company & Securities Law Journal* 151, 164.
[783] Australian Securities and Investments Commission, above n 647, 25.

legal reform needs to be regularly reviewed in order for it to be consistent with the public interest.

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APPENDIX 1

Treasury CLERP – Policy Framework 'Economic Approach to Business Regulation' [784]

3.1 Market Freedom

Competition plays a key role in driving efficiency and enhancing community welfare. However, free markets do not always operate in a sufficiently competitive, equitable or efficient manner. Business regulation can and should help markets work by enhancing market integrity and capital market efficiency. At the same time, the regulatory framework needs to be sufficiently flexible so that it does not impede market evolution (for example, new products and technologies) and competition.

3.2 Investor Protection

With an increasing number of retail investors participating in the market for the first time, business regulation should ensure that all investors have reasonable access to information regarding the risks of particular investment opportunities. Regulation should be cognisant of the differences between sophisticated and retail investors in access to information and the ability to analyse it.

3.3 Information Transparency

Disclosure is a key to promoting a more efficient and competitive marketplace. Disclosure of relevant information enables rational investment decision making and facilitates the efficient use of resources by companies. Disclosure requirements increase the confidence of individual investors in the fairness and integrity of financial markets and, by fostering confidence, encourage investment. Different levels of disclosure may be required for sophisticated and retail investors.

3.4 Cost Effectiveness

The benefits of business regulation must outweigh its associated costs. The regulatory framework should take into account the direct and indirect costs imposed by regulation on business and the community as a whole. What Australia must avoid is outmoded business laws which impose unnecessary costs through reducing the range of products or services, impeding the development of new products or imposing system-wide costs.

The regulatory framework for business needs to be well targeted to ensure that the benefits clearly exceed the costs. A flexible and transparent framework will be more

[784] Treasury, above n 6.

conducive to innovation and risk taking, which are fundamental elements of a thriving market economy, while providing necessary investor and consumer protection.

3.5 Regulatory Neutrality and Flexibility

Regulation should be applied consistently and fairly across the marketplace. Regulatory distinctions or advantages should not be conferred on particular market structures or products unless there is a clear regulatory justification. The regulatory framework should also avoid creating incentives or opportunities for regulatory arbitrage.

The regulatory framework should be sufficiently flexible to permit market participants to respond to future changes in an innovative, timely and efficient manner. Regulation should be designed to facilitate predictability and certainty.

3.6 Business Ethics and Compliance

Clear guidance regarding appropriate corporate behaviour and swift enforcement if breaches occur are key elements in ensuring that markets function optimally.

The Government is committed to the strong and effective enforcement of corporate law and will continue to provide substantial resources to the Australian Securities Commission [now the Australian Securities and Investments Commission (ASIC)] to enforce the law.

Fostering an environment which encourages high standards of business practice and ethics will remain a central objective of regulation, as will effective enforcement.

APPENDIX 2

Australian Securities and Investments Commission, Report 317: Audit inspection program public report for 2011-12

The text of the Australian Securities and Investments Commission, Report 317: Audit inspection program public report for 2011-12 is attached as Appendix 2.

ASIC
Australian Securities & Investments Commission

REPORT 317

Audit inspection program report for 2011–12

December 2012

About this report

This report summarises the observations and findings identified by ASIC's audit inspection program in the 18 months to 30 June 2012.

We expect this report to be of significant interest both to the inspected firms and those firms we have not inspected, as well as companies, audit committees, investors and other stakeholders interested in financial reporting.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Scope

Sections of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices or conduct of some of the 20 audit firms inspected. The absence of a reference in this report to any other aspect of a firm's systems, policies, procedures, practices or conduct is not an approval by ASIC of those aspects, or any indication that in ASIC's view those aspects comply with relevant laws and standards.

In the course of reviewing specific areas in a limited sample of selected audit engagements, an inspection may identify ways in which a particular audit is deficient. It is not the purpose of an inspection, however, to review all of the firm's audit engagements or to identify every aspect in which a reviewed audit may be deficient. Accordingly, this report does not provide assurance that the firms' audits, or their clients' financial statements, are free of deficiencies apart from those described in this report.

Unless stated otherwise, not all matters in this report apply to every firm and, where they do apply to more than one firm, there will often be differences in degree. Our observations and findings relate only to the individual firms inspected. Our observations and findings can differ significantly, even between firms of similar size, and for that reason we caution against drawing conclusions about any individual firms.

This report covers audit firm inspections only and does not include any matters arising from other ASIC regulatory activities, such as our financial reporting surveillance program, and investigations or surveillances of the firms or the entities that they audit. However, these other activities may inform general areas of focus in inspections.

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Executive summary

1 This report covers the findings from our inspections of 20 Australian audit firms substantially undertaken in the 18 months to 30 June 2012. Our inspections focus on audits of financial reports of public interest entities prepared under the *Corporations Act 2001* (Corporations Act).

2 We are disappointed that there has not been an improvement in audit quality since our last report for the 18 months to 31 December 2010. Our risk-based reviews have shown an increase in instances where auditors did not perform all of the procedures necessary to obtain reasonable assurance that the audited financial report was not materially misstated.

3 Australia's audit regime is similar to the regimes in other major developed countries. We understand that audit oversight regulators in a number of other countries have experienced similar trends in audit quality.

4 Firms should increase their efforts to improve audit quality and the consistency of audit execution. This report identifies some important areas where the firms need to focus their attention and make improvements to ensure consistent audit quality.

5 We have identified three broad areas requiring improvement by audit firms:

(a) the sufficiency and appropriateness of audit evidence obtained by the auditor;

(b) the level of professional scepticism exercised by auditors; and

(c) the extent of reliance that can be placed on the work of other auditors and experts.

6 We found that, in 18% of the 602 key audit areas that we reviewed across 117 audit files over firms of all sizes, auditors did not obtain sufficient appropriate audit evidence, exercise sufficient scepticism, or otherwise comply with auditing standards in a significant audit area. While the financial reports audited may not have been materially misstated, in these instances, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement: see Section A.

7 Some audit firms inspected need to improve their quality control systems: see Section B.

8 Further, we believe there are a number of actions that audit firms should consider to improve and maintain audit quality: see Section C.

9 In this report, we also outline future areas of focus for audit firms and our inspections: see Section D.

A Key findings: Audit file reviews

Key points

We have identified three broad areas requiring improvement by audit firms:

- the sufficiency and appropriateness of audit evidence obtained by the auditor;
- the level of professional scepticism exercised by auditors; and
- the extent of reliance that can be placed on the work of other auditors and experts.

We found that, in 18% of the 602 key audit areas reviewed by us across 117 audit files over firms of all sizes, auditors did not obtain sufficient appropriate audit evidence, exercise sufficient professional scepticism, or otherwise comply with auditing standards in at least one significant audit area.

While the financial reports audited may not have been materially misstated, in these instances, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement.

In this section, we also outline our findings on audits for specific industries.

Adequacy of audit procedures

10 Auditors are important 'gatekeepers' in our financial system. The quality of an audit supports high quality financial reports, informed investors and market confidence.

11 The objective of our inspections is to work co-operatively with firms to improve and maintain audit quality.

12 We are disappointed there has not been an improvement in audit quality since our last report for the 18 months to 31 December 2010. Our risk-based reviews have shown an increase in instances where auditors did not perform all of the procedures necessary to obtain reasonable assurance that audited financial reports were not materially misstated.

13 Australia's audit regime is similar to the regimes in other major developed countries. We understand that audit oversight regulators in a number of other countries have experienced similar trends in audit quality.

14 There are some important areas where the firms need to focus their attention and make improvements to ensure audit quality. While firms have indicated a commitment to improving audit quality, they should increase their efforts to improve audit quality and the consistency of audit execution.

15 We reviewed a number of key aspects in 117 audit files at the 20 audit firms that we inspected during the 18 months to 30 June 2012. Our inspections covered four to six key audit areas on each file. Across the 117 files, we reviewed 602 key audit areas in total. The appendix contains further information about our inspection approach and the 20 audit firms inspected.

16 In 18% of the 602 key audit areas reviewed in 117 audit files, in our view auditors did not obtain sufficient appropriate evidence, exercise sufficient professional scepticism, or otherwise comply with auditing standards. In these instances, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement. For the previous 18-month reporting period to 31 December 2010, we noted the same findings in 14% of the key audit areas we reviewed.

17 The occurrence of the above findings at the larger firms was:

(a) Larger National firms—13% (10% in the previous 18-month period); and

(b) Other National and Network firms—21% (18% in the previous 18-month period).

Note: See paragraph 90 in the appendix for an explanation of the firm size categories.

18 Matters relevant to understanding our findings and the percentages reported above are outlined in Table 1. The percentages reflect findings in the areas discussed later in this section.

19 The auditing standards state that the fundamental objective of the audit is to obtain reasonable assurance that the financial report as a whole is free of material misstatement. Audit firms should consider ways to further improve audit quality and significantly reduce the number of instances where this assurance is not obtained.

20 Section C of this report outlines good practices adopted by auditors, and other matters for consideration by firms to promote improved audit quality. Section D contains specific focus areas for firms. We will also engage with firms on how they propose to address the findings in this report and reduce the percentages of findings.

21 Better auditors appropriately balance commercial pressures with risks and maintaining audit quality. They ensure that they understand the audited entity's business model, its internal and external risks, and how these factors affect the nature and extent of audit procedures.

22 There will be instances where auditors detect material misstatements during the audit process and these misstatements are corrected before a financial report is completed and released. These instances are not measured in this report.

Table 1: Matters relevant to understanding findings

Matter	Explanation
Quality of financial reports	An adverse finding on a matter during our review does not necessarily mean that there will be material misstatements in the overall financial report. Rather it means that the auditor has not in ASIC's view obtained reasonable assurance that there are no such misstatements. In two separate instances, where we had identified concerns with audit work, we followed up the matters directly with the companies, resulting in material changes to their financial reports. In one case, where we identified inadequate audit work, the firm performed additional audit work and did not identify material misstatements in the financial report concerned. Generally, firms implement our suggested remedial actions for future company audits where we identify concerns. Auditors play an important role in checking financial information to ensure that it is accurate before financial reports are released to the market.
Level of assurance	An audit is not intended to provide absolute assurance that there are no material misstatements in the financial report. Our findings relate to instances where we believe that the auditor has not obtained reasonable assurance that the financial report as a whole is free of material misstatements.
What is measured?	The percentages listed in paragraph 17 relate to cases where auditors did not obtain sufficient appropriate audit evidence, exercise sufficient judgement, or otherwise comply with auditing standards in key audit areas, such that the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement. The percentages do not include other findings relating to audit quality and compliance with auditing standards, such as the adequacy of planning, obtaining an understanding of business, risk assessment, reviews and reliance on internal controls, non-substantive analytical procedures, documentation, supervision and review, auditor independence, firm quality control systems, and training of partners and staff. The percentages also exclude findings concerning insufficient work for related party transactions, reviews for unusual journal entries, review of legal expenses and legal representation letters, and subsequent event reviews. These matters could have resulted in material misstatements not being detected. Although excluded from the percentages, these remain important areas for improvement by firms.
Other National and Network firms	We inspected different groups of Other National and Network firms in the 18 months to 30 June 2012 and the 18 months to 31 December 2011. Firms inspected generally improve audit quality after our first inspection. In the 18 months to 30 June 2012, all firms had been previously inspected. In the 18 months to 31 December 2011, two firms had been inspected for the first time. This may have resulted in a smaller increase in the percentages above than would otherwise have been the case.
Subjectivity	Our findings relate to compliance with the auditing standards. Audits necessarily involve the application of professional judgement and there are some instances where different individuals will reach different judgements on whether the audit work performed is sufficient. Each of our inspection findings is subject to quality review within ASIC, and extensive discussion and consultation with the engagement partners and firms.

Matter	Explanation
Enforcement action	The objective of our inspections is to work co-operatively with audit firms to improve and maintain audit quality. We expect audit firms to make changes and to undertake work in response to our findings. However, there are some cases where findings are so serious as to warrant enforcement or similar action. We are currently considering possible enforcement action on concerns arising in the 2011–12 review period from our inspection of a Smaller firm. Further, as a result of inspections conducted in the 2009–10 review period and reported on in our previous report, one auditor from an Other National and Network firm and one auditor from a Smaller firm have chosen not to continue as registered company auditors.
Impact of risk-based approach	Our reviews of audit files do not cover all areas of an audit engagement or all subsidiaries and divisions in a group. Typically, four to six key audit areas are covered and, for groups, only one major operating component. We select audit engagements and key audit areas for review in our audit inspections using a risk-based approach. Some have suggested that this approach could result in the percentages reported being greater than would be the case with random reviews. On the other hand, more experienced partners and staff are usually allocated to such audits, and there are generally more extensive firm reviews and consultation processes for these audits and the key audit areas. Our experience is that there can be more findings relating to smaller audit engagements.
Documentation versus audit evidence	If audit work is not documented, our presumption is that the work has not been performed in the absence of evidence to the contrary. This is the same approach applied by other audit oversight regulators and by most firms in their internal quality review programs.
Surveillances and investigations	ASIC is both an audit oversight regulator and a securities regulator. In addition to audit inspections, we conduct a range of other activities that relate to the work of audit firms. These other activities include our financial reporting surveillance program, surveillances where there is a concern about a specific audit or an individual auditor, and investigations into corporate failures. Where our concerns about material misstatements in financial reports have originated from these other activities, the audits are not reviewed in our audit inspection program but are the subject of separate auditor surveillance activities. This report does not cover any of these other activities. The outcomes of these activities are reported in separate media releases and our regular enforcement reports. However, these other activities can inform our general areas of inspection focus and the timing of future audit firm inspections.
Number of procedures and findings	There may be a number of audit procedures in a key audit area. Findings have been included in the percentages reported where there was only one instance of the auditor not performing an audit procedure in any given key audit area, if that meant the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement. The percentages reported refer to audit areas where we had findings that insufficient work had been performed such that material misstatements would not be detected, irrespective of the number of findings for any particular audit area. There were a number of cases where we found more than one deficiency in a key audit area, each of which could have resulted in material misstatements not being detected.
Process improvement	Where firms put in place initiatives to improve audit quality, there can be a period before the benefits are realised through improved audits.

Audit evidence

23 Our reviews of audit files across the firms inspected raised a high number of concerns about the sufficiency and appropriateness of evidence obtained by auditors to support their conclusions on significant areas of the audit. Findings were mainly in the areas outlined below.

Impairment testing and fair value measurement

24 In an environment of global economic uncertainty, we continued to focus on impairment of assets and the measurement of assets and liabilities at fair value, which are important areas of judgement. In many audit files, auditors had not obtained sufficient appropriate audit evidence to support the values of assets and liabilities in the financial report. This included, but was not limited to, financial instruments, goodwill, other intangible assets, development property inventories, property plant and equipment, carrying values of a controlled entity or joint venture investment in an associate, capitalised expenditure and provisions.

25 In many files, we found the auditor had not adequately tested:

(a) the audited entity's impairment model and assumptions, including the discount rates, forecast cash flows, growth rates, number of cash generating units (CGUs), and inclusion or exclusion of items such as working capital and tax losses; and

(b) the accuracy of the source data used by the audited entity in estimating future cash flows used for impairment assessments.

26 In some files, audit evidence was insufficient or inappropriate to confirm:

(a) the valuation of financial assets recorded at fair value because the auditor relied on external confirmations, which verified the existence but not necessarily the valuation of the assets;

(b) the annual assessment of impairment of goodwill (instead, the auditor relied on assessments prepared by the audited entity in a previous year); and

(c) consideration by the auditor of whether an expert may be required to assist the auditor, particularly with complex impairment calculations relying on significant judgement.

27 We also found insufficient evidence that the auditor exercised professional scepticism in:

(a) critically evaluating whether discount rates used by audited entities reflected the risks specific to the relevant industry or a particular CGU, or challenged the appropriateness of high growth rates used by clients even though the audited entity's historical performance indicated otherwise; and

(b) considering whether disclosures in the financial report about fair value and impairment were in accordance with the relevant accounting standards. In particular, we noted that, even though impairment indicators and sensitivities about a reasonable possible change in assumptions leading to impairment were communicated to those charged with governance of the audited entity, these were not disclosed in the financial report. Where disclosure deficiencies were identified, it often appeared that the auditor was willing to agree with the audited entity's disclosures rather than challenge them.

Assessment of going concern

28 Our inspections continued to show that auditors had not always obtained sufficient appropriate audit evidence to demonstrate their consideration of the going concern assumption or whether an emphasis-of-matter paragraph (or qualification) should be included in the audit report.

29 In many of the audit files we reviewed, we had concerns about the adequacy of the audit procedures undertaken and the level of professional scepticism applied by the auditor in assessing whether:

(a) the auditor's report should be modified with an emphasis-of-matter paragraph about the use of the going concern assumption. In one instance, an emphasis-of-matter paragraph had previously been included in the auditor's report but was removed when there did not appear to be a substantial change in the financial performance of the audited entity;

(b) the entity's going concern assumption was appropriate, particularly where the entity operated in an environment of significant environmental and political risk; and

(c) the audited entity's budgeting and cash flow forecasting were reasonable and the auditor was able to rely on management's key assumptions about the budget and forecast.

Substantive analytical procedures

30 In many audit files, the auditor had not complied with auditing standards in the application of substantive analytical procedures used as the primary substantive test for a material balance.

31 When using substantive analytical procedures, the auditor should ensure that there are appropriate relationships between the data used and the balances tested, that the source data is adequately tested, and that suitable thresholds are developed and explanations for variances are obtained and corroborated.

32 While our findings relate to the audit of all types of companies and industries, the findings were particularly common in the audit of financial institutions: see paragraphs 48–54. We found many instances where auditors:

(a) relied on substantive analytical procedures as the only substantive test for a material balance where other procedures such as testing of controls and substantive tests of detail were not undertaken;

(b) did not ascertain the accuracy of the data used in the analytical procedure and whether there was an appropriate relationship between the data used and the population being audited;

(c) did not adequately set expectations before carrying out the analytical procedure;

(d) did not sufficiently investigate differences between the expectation set and the recorded balance;

(e) used disaggregated data for the substantive analytics, but did not set appropriate disaggregated thresholds for following up variances from expectations; and

(f) used simplistic analytical comparisons which did not satisfy the requirements of the auditing standard for designing and performing substantive analytical procedures.

Journal entry testing

33 Auditing standards require an auditor, in considering the risk of fraud in an audit of a financial report, to test the appropriateness of journal entries during the preparation of the final report. Further, the auditor should consider the need to test journal entries throughout the reporting period.

34 We found many audit files where the auditor:

(a) did not test journal entries during the year-end reporting or consolidation process; and/or

(b) did not test journal entries throughout the year.

Related party transactions

35 In many audit files, the auditor did not perform adequate procedures to gain sufficient appropriate audit evidence about whether all related parties and related party transactions were fully identified and disclosed in the financial report. We often found that auditors:

(a) did not adequately assess, discuss and document, at the planning stage of the audit, the risk of undetected related parties and related party transactions;

(b) did not adequately discuss with management the risks of undetected related party transactions or obtain an understanding of the audited

entity's systems and controls for identifying them, but instead relied on a list of related parties and related party transactions provided by the audited entity without undertaking additional work to determine whether there were any undetected related party transactions;

(c) did not document the design and operation of the audited entity's controls to detect related party transactions; and

(d) did not assess whether related party transactions were fully disclosed in the audited entity's financial report.

Subsequent events review

36 We noted many instances where auditors did not obtain sufficient evidence to support their conclusions about subsequent events. We found cases where:

(a) there was no evidence in audit files that subsequent event procedures were performed by the auditor;

(b) the auditor conducted subsequent event procedures but did not ensure they were carried out up to the date of signing the audit report; and

(c) a subsequent event was disclosed in a financial report but there was no evidence that the auditor had performed procedures on the item or considered whether other material subsequent events had occurred.

External confirmations

37 While there is no mandatory requirement to obtain external confirmations, we consider that they are a reliable source of independent evidence. Despite this, we found instances where the auditor:

(a) did not carry out adequate alternative procedures to verify the existence and valuation of assets held overseas where confirmations requested by the auditor for those assets had not been received; and

(b) did not evidence why external bank confirmations were not obtained for material cash balances but instead relied on bank statements provided by the audited entity.

Consideration of the risk of fraud

38 In many instances, we found that the auditor had not discussed with management, or those charged with the governance of the audited entity, the risks of fraud that could have a material impact on the financial report.

39 We found other instances where the auditor did not adequately consider the risk of fraud in relation to revenue recognition, which might be considered a heightened risk in the current economic environment.

Professional scepticism

40 Exercising professional scepticism is a critical part of conducting quality audits. Professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of the audit evidence obtained and the management's judgements on accounting treatments and estimates.

41 Our reviews of audit files showed insufficient professional scepticism was applied, particularly in relation to fair value measurement, impairment testing, and going concern assessments: see paragraphs 24–29.

42 We found many instances where auditors:

(a) appeared to have been over-reliant on, or readily accepted, the management's explanations and representations without challenging the underlying assumption, or instead sought out evidence to corroborate the estimations or judgements rather than challenging them;

(b) had not explored the evidence available in other parts of the audit file that appeared inconsistent or contradictory; and

(c) had not given sufficient consideration to historical outcomes in assessing the reasonableness of the forecasts and assumptions underlying the management's decisions.

43 Auditors did not always evidence why an accounting treatment proposed by management was accepted and whether alternative scenarios or accounting treatments were fully considered. In judgement areas, it is necessary at times to rely on evidence that is persuasive rather than conclusive. However, in some instances the auditor did not give sufficient weight to evidence that appeared to contradict the accounting treatment adopted.

Using the work of other auditors and experts

44 Often, if an auditor is responsible for the audit of a financial report consolidating many business components, the firm relies on the audit work performed by component auditors that may be affiliated, or separate firms, potentially located in a foreign jurisdiction.

45 Where financial reports include complex or subjective matters requiring specialist skills or knowledge (e.g. valuations of assets), audited entities may obtain advice from external or internal experts. Auditors may also use their own specialists to obtain sufficient appropriate audit evidence for significant account balances in the financial report.

46 For an auditor to rely on the work of other auditors and experts, the auditor needs to assess their competence and objectivity, and evaluate the appropriateness of the work performed by them.

47 We found instances where the audit files did not contain sufficient appropriate evidence of:

(a) the auditor's evaluation of the competence and independence of component auditors and the evaluation of the component auditors' work, including the resolution of matters raised by component auditors;

(b) the auditor's evaluation of the adequacy and reliability of the work of experts engaged by the audited entity, particularly in the case of financial institutions where experts are used to measure complex and material liabilities and provisions, or to provide pricing information;

(c) where financial institutions use a service organisation to process a material transaction stream, the auditor's assessment of the work of the auditor of the service organisation and whether it could be relied on; and

(d) the appropriate translation of source documents from a foreign language into English (e.g. bank statements).

Industry-specific findings

Financial institutions

48 We reviewed audit files for financial institutions, including banks, credit unions, insurance companies and managed investment schemes. We reviewed the audits of Australian financial services (AFS) licensee obligations (see paragraph 54) and compliance plan obligations (see paragraphs 55–57).

49 Our reviews of these files highlighted findings common to all industries, such as not obtaining sufficient appropriate evidence to support audit procedures conducted in relation to assessing impairment, the application of professional scepticism, the performance of substantive analytical reviews, and relying on the work of others: see paragraphs 23–47.

50 Key findings specific to the audit of banks and credit unions include:

(a) insufficient and inappropriate audit evidence obtained to support the valuation of significant financial assets, such as trading derivatives, trading securities and available-for-sale securities. In particular, we found instances where the auditor's substantive procedures were inadequate and the auditor placed inappropriate reliance on controls and external confirmations to validate the valuation assertion;

(b) insufficient testing to assess the adequacy of provisions for loan losses. In designing a disaggregated substantive analytical procedure, one auditor used an aggregated threshold for testing, and did not clearly identify a threshold for investigating differences or sufficiently corroborate variations identified; and

(c) insufficient testing of the reported net interest margin, including the inappropriate application of substantive analytical procedures or reliance on the audited entity's controls without detailed substantive testing where the balance was material.

51 Key findings specific to the audit of *insurance companies* include:

(a) not exercising sufficient professional scepticism about the sufficiency of the level of the 'liability adequacy' provision and the calculation of the 'probability of adequacy' for outstanding claim provisions where a significant amount of judgement is applied in the calculation. We found that the auditor accepted and relied on the audited entity's assumptions and assertions without sufficient challenge, including, in one instance, not questioning a material change to the probability of adequacy calculation;

(b) insufficient assessment by the auditor of whether work performed by the firm's internal actuarial experts on insurance liability provisions (including outstanding claims liabilities, premium liabilities and liability adequacy test) could be relied on and was sufficient to support their conclusions on the adequacy of the provisions;

(c) inappropriate assessment of risk and, consequently, insufficient substantive testing of material management fee revenue; and

(d) inadequate testing of key controls in the audited entity's underwriting system and insufficient testing to confirm internal controls operated for the entire audit period, where the controls were tested at the interim audit and the auditor relied on those controls.

52 The findings in paragraphs 50–51 do not necessarily mean that there were deficiencies in the systems of any of the regulated entities concerned.

53 In addition, our reviews of audits of banks, credit unions and insurance companies found that sampling procedures were often inappropriate. For example, there was often insufficient evidence that the auditor considered whether the sample selected was representative of the whole population or whether sampling was undertaken in accordance with the firm's policy.

54 We conducted reviews of audits of AFS licensees and found instances where the auditor's procedures for testing net tangible assets (NTA) could have been improved by selecting an adequate sample size to support conclusions on the maintenance of NTA requirements and by sufficiently reviewing the audited entity's adjustments to NTA.

Compliance plans

55 In this reporting period, we carried out inspections of compliance plan audits for managed investment schemes conducted under s601HG(1) of the Corporations Act.

56 Where functions such as custodial or investment administration or back-office accounting are outsourced, auditors often choose to rely on a report prepared by the auditor of the service organisation reporting on the design, implementation and/or effectiveness of operating controls, or in relation to specific assertions such as valuation and existence of investments.

57 We found that auditors of compliance plans did not always obtain sufficient and appropriate audit evidence on which to base their conclusions in areas such as:

(a) whether the compliance plan continued to meet the requirements of Pt 5C.4 of the Corporations Act;

(b) the adequacy of procedures for reporting and assessing breaches of the compliance plan;

(c) the assessment of whether the service organisation auditor's report could be relied on in relation to outsourced functions, risk assessments performed by the auditors, and the relationship to work performed on areas of the compliance plan audit; and

(d) the testing of specific areas, such as subsequent events up to the date of issuing the compliance plan audit report, NTA calculations (for the responsible entity), and cash flow projections.

Mining and energy

58 Companies in the mining and energy sector often have associations with overseas countries, including emerging economies where the materials and resources are situated. Consequently, auditors need to rely on the work of other auditors in the overseas countries, which may have different regulatory frameworks, professional standards and culture.

59 In the majority of mining and energy sector files reviewed, we found common cases where the auditor did not obtain sufficient appropriate audit evidence to:

(a) corroborate the existence of tenements;

(b) confirm the existence and valuation of other significant and material asset balances, such as capitalised exploration, evaluation or development expenditure; and

(c) assess the reliance that could be placed on the work of the audited entity's expert.

60 In many of these cases, the auditor did not exercise professional scepticism. Often the auditor did not challenge the audited entity's key assumptions and relied on evidence presented by management to support judgements such as forecast cash flows. We noted that, although mining and energy entities often operate in an environment subject to significant uncertainty, or political and/or environmental risk, there was insufficient evidence of the auditor's procedures to objectively assess the going concern assumption.

B Key findings: Quality control

Key points

Some firms need to improve their quality control systems to ensure they comply with the independence requirements of the Corporations Act and professional standards. In particular, firms need to manage auditor rotation more effectively.

Although firms have generally implemented the Clarity auditing standards well, compliance with certain aspects of these standards can be improved.

Some of the Other National and Network firms and the Smaller firms can improve their human resources policies and systems, and the effectiveness of their internal monitoring programs.

Ethical requirements and independence

61 Larger National firms and Other National and Network firms have established independence policies and processes to facilitate compliance with the auditor independence requirements of the Corporations Act and professional standards. Across these firms, leaders remain committed to an appropriate 'tone at the top' that emphasises the importance of audit independence. However, we noted the following instances of non-compliance with legislative and professional requirements.

Contraventions of the auditor rotation requirement

62 One Larger National firm advised us of two contraventions of the Corporations Act, where the engagement quality control reviewer (EQCR) played a significant role on an engagement for more than five years. While the firm had a process for recording and monitoring the period of time an EQCR is assigned to an engagement, the contraventions occurred because the partner rotation information recorded in the audit file was not reconciled to the firm's central record. After considering the circumstances specific to each case, the firm disciplined the engagement partner and EQCR in relation to one of the breaches. In addition, the firm reminded all audit partners to ensure that the rotation information recorded in the audit file agrees with the firm's central record.

63 At a Smaller firm, we found that the auditor rotation requirements had been contravened for two listed audit clients, where both the engagement partner and EQCR had acted in their roles for more than five years, and there was a risk that the rotation requirements would be contravened for three other listed clients. The Smaller firm has since established an authorised audit company with three directors. This will enable the firm to meet the auditor rotation requirements.

64 Our inspection of Smaller firms identified that Smaller firms are at a higher risk of not managing mandatory auditor rotation effectively. Smaller firms need to put in place systems to ensure that they can comply with the auditor rotation requirements of the Corporations Act.

Contraventions of other independence requirements

65 At one Larger National firm, we found two instances of threats to perceived independence in connection with listed clients. One instance concerned the non-routine change of the engagement partner following a deterioration in the relationship with the Chief Financial Officer after the partner challenged an accounting treatment that was changed with agreement of the audit committee. The other instance concerned the provision of non-audit services to the client. We believe that more extensive and complete consultations, outlining all relevant circumstances, should have taken place within the firm in question and with those charged with governance of the clients. The assessment of threats and safeguards to independence should have been more thoroughly considered and documented by the firm.

Testing of independence systems

66 Many of the Other National and Network firms inspected did not test their independence systems and processes, including the declaration of financial interests, to ensure they were meeting the requirements of the Corporations Act and professional standards. While this is not a requirement of the Act, testing independence systems would enable the firms to place greater reliance on the effectiveness of their systems, and could highlight potential non-compliance with the independence requirements. Without an appropriate testing program, firms can only place limited reliance on the effectiveness of their independence systems and processes.

Acceptance and continuance

67 Client acceptance and continuance procedures should focus on independence considerations, possible conflicts of interest, and whether the firm has the requisite skills to conduct an engagement (as required by auditing standard ASQC 1 *Quality control for firms that perform audits and reviews of financial reports and other financial information, and other assurance engagements*).

Opinion shopping

68 A potential audit client sought assurances from one Larger National firm that the firm did not foresee challenging the company's existing accounting treatments, and questioned the potential for the firm to qualify its audit opinion on a particular accounting treatment where the firm had qualified its audit report on another company's financial statements on a similar matter. Leaders of firms should be vigilant about the possibility of 'opinion shopping' and ensure that firm acceptance and continuance processes and training for partners and staff specifically address this threat.

Conflict checking

69 One Smaller firm relied on a national database to check for conflicts of interest and threats to independence when accepting a new client. The national database appeared to be updated periodically and used on an ad hoc basis. The Smaller firm did not obtain positive confirmations from all partners and directors about potential conflicts and threats to independence when assessing the acceptance of a new listed client.

70 Leaders of all firms need to continue to give strong and clear messages about the importance of complying with independence requirements, and take strong and timely action where non-compliance is noted to ensure that an appropriate 'tone at the top' is maintained.

Engagement performance

71 Although the Clarity auditing standards have been implemented well across the firms, some Other National and Network firms can improve systems and processes for compliance with certain aspects of the standards relating to:

(a) relying on the work of component auditors (see paragraphs 44–47);

(b) testing journal entries throughout the year (see paragraphs 33–34); and

(c) related party transactions (see paragraph 35).

Human resources

72 Larger National firms have mature quality control systems with clear links between audit quality, independence and ethical requirements, and partner and director appraisal and remuneration. However, we found that some of the Other National and Network firms and the Smaller firms can improve their policies and internal systems in this area.

Monitoring

73 Larger National firms have comprehensive policies and procedures for monitoring their audit quality in accordance with legal and professional requirements. These firms undertake regular reviews of a selection of completed audit engagements. They use the results of these reviews to enhance their audit quality systems and direct the focus of staff training.

74 Although Other National and Network firms have procedures in place to facilitate the monitoring of audit quality as required by ASQC 1, we note that improvements can be made to these programs, including:

(a) ensuring that:

(i) monitoring programs cover an effective partner spread;

(ii) files are selected on the basis of risk;

(iii) files are reviewed for compliance with auditing standards; and

(iv) the results of reviews are documented and communicated to partners and staff;

(b) promptly following up and remediating issues identified through monitoring programs, including taking appropriate action against partners who are repeat offenders;

(c) ensuring that internal monitoring programs not only review individual audit files, but also review the firm's compliance with quality controls systems as required by ASQC 1; and

(d) sharing the results of internal monitoring programs and peer reviews across firms that are members of a network to further promote and enhance audit quality across the network.

75 Firms need to improve their processes for recording and notifying ASIC of contraventions and suspected contraventions of the Corporations Act, including contraventions of the independence requirements. Members of network firms should also implement a national register of notifications to ensure consistency in the identification, consideration and reporting of matters. For guidance about the auditor's obligation to report to ASIC, see Regulatory Guide 34 *Auditor's obligations: Reporting to ASIC* (RG 34) at www.asic.gov.au/rg.

76 We found that the majority of Smaller firms had not established a monitoring program to periodically review a selection of completed audit files. Through the evaluation and monitoring of their quality control systems, these firms can assess whether their systems are operating effectively to facilitate compliance with professional standards and other relevant legal and regulatory requirements. Some Smaller firms rely on the reviews undertaken by ASIC, The Institute of Chartered Accountants in Australia and CPA Australia, but these are not a substitute for the firm's own internal monitoring program.

C Improving and maintaining audit quality

Key points

Firms should consider ways to improve and maintain audit quality, particularly in relation to audit evidence, professional scepticism, and the use of other auditors and experts.

This section summarises matters raised by ASIC with individual firms to improve audit quality in their circumstances.

Areas to consider

77 Firms should consider ways to improve and maintain audit quality, particularly in relation to audit evidence, professional scepticism, and the use of other auditors and experts. There should be clear individual accountability for making improvements necessary to achieve a firm's overall plan.

78 Table 2 contains examples of good practice and suggested actions that ASIC has included in private audit inspection reports issued to audit firms inspected during the 18 months to 30 June 2012. These matters may also be of assistance to other firms.

79 Of course, the relative importance of each matter for a firm, and the extent of work to be done, will vary from case to case. Firms may have taken some actions in the areas outlined in Table 2, but may need to do more to reduce the cases where reasonable assurance is not obtained about whether the financial report as a whole is free from material misstatement.

Table 2: Examples of good practice and matters reported by ASIC to individual firms

Area	Good practice suggestions
Audit evidence	This table includes matters that are relevant to reducing the number of cases where sufficient appropriate audit evidence is not obtained to support the auditor's opinion. These include training, guidance, supervision and review, remuneration policies and firm quality reviews.
Professional scepticism	Professional scepticism must be maintained and exercised throughout the planning and performance of an audit. Engagement partners and staff should have questioning minds, obtain a full understanding of all relevant facts, not be over reliant on management's explanations and representations, and not just seek to obtain audit evidence that corroborates rather than challenges management's judgement. Partners and staff must have a sound knowledge of the accounting standards and framework to conduct an effective audit. When considering accounting treatments, partners and staff should consider the substance of arrangements, alternative views and the principles and intent of accounting standards in making their judgments.

Area	Good practice suggestions
	In our reviews, we observed that firms with better practices supported professional scepticism through measures including: • fostering a strong firm culture of promoting and supporting professional scepticism (e.g. through strong and consistent messages from firm leaders and supporting professional scepticism in individual cases); • sending clear, consistent and genuine messages from firm leadership, partners and managers that professional scepticism and audit quality must not be compromised to meet deadlines and budgets, to support a particular outcome desired by management, or to protect fees; • ensuring that partners and staff assigned to audit engagements had strong understanding of the audited entity's business, appropriate industry knowledge, experience and a sound understanding of the financial reporting requirements; • providing education and training, firm guidance and procedures, consultation processes, technical support, effective supervision and review (including engagement quality control reviews), and firm quality control reviews; • not using emphasis-of-matter provisions as an 'easy' alternative to issuing a qualified audit opinion; and • implementing independence policies, systems and processes to support objectivity. This includes re-evaluating decisions made in previous audits and regularly bringing fresh minds to bear.
Use of other auditors	We reported instances where firms should review their approaches to the use of other auditors to ensure that they obtain sufficient appropriate independent evidence to support their audit opinions. This included in the context of group audits (particularly in connection with business components in emerging markets), interests in joint ventures, and the use of service organisations. This work can include assessing the other auditors and reviewing their audit work. There may be a cost associated with this work.
Use of experts	Auditors should obtain independent assurance in relation to the work undertaken by company experts and experts engaged by companies. We reported instances where firms should have engaged their own independent expert as the auditor did not have the necessary skills, knowledge and experience. Where the auditor uses internal firm experts or external experts, sufficient audit work must be performed on any source information used by those experts.
Understanding the business and risks	In the better audits, engagement partners brought their knowledge and experience to the process of assessing the audited entity's business model, its internal and external environment and risks, and how these factors affect the nature and extent of audit procedures.
Expertise and experience	In some cases, firms needed to ensure that partners and staff assigned to particular individual engagements had suitable industry and audit experience, taking into account the nature of the audited entity, the risks associated with the audited entity and its business environment, any complexities (e.g. the use of complex financial instruments), the level of professional judgement required and the likely planned audit approach.
Training and guidance	Many firms have introduced additional training and guidance on audit evidence, professional scepticism, professional judgement and reliance on other auditors and the use of experts. We reported that consideration should be given to further training and guidance to address adverse findings. Smaller firms may outsource additional training and development of guidance, and/or use any relevant training courses and guidance produced by accounting bodies or others.

Area	Good practice suggestions
Supervision and review	Firms with better practices ensure strong and effective supervision and review at all stages of the audit, from planning and performance to concluding procedures, which are essential to audit quality. Reviews are timely and comments raised are properly addressed and cleared by the reviewer. The importance of supervision and review is emphasised through training and quality reviews.
Reliance on internal auditors	Given that internal auditors are employed by the audited entity and cannot be fully independent, firms with better practices consider the extent to which internal audit work can be relied upon in the external audit and limit the use work of internal auditors in important audit areas.
Deadline pressures	To deal with tight reporting deadlines, examples of better practices adopted by firms include reviewing major new transactions, contentious accounting treatments and financial report formats before year end.
Use of substantive analytical procedures	We reported that firms should ensure that any reliance on substantive analytical procedures is appropriate and does not lead to false efficiencies. For example, there should be strong messages from firm leadership and through training that: • models to predict balances in the financial report are based on relationships that make sense; • data used is independent of the population being predicted; • thresholds are appropriate and not revised based on variances identified; • auditors exercise scepticism in considering management's explanations for significant variances noted; and • independent audit evidence is obtained to corroborate explanations for variances.
Auditor independence	Larger firms have systems and monitoring processes relating to audit independence, as well as training, guidance and support in considering possible threats to independence. More should be done, particularly by other firms.
Remuneration	The remuneration of partners and managers should be linked to audit quality, as assessed through firm quality reviews and audit inspection findings. We reported that a number of firms need to improve their policies and processes in this area.
Material disclosures	We reported that some firms should consider additional training, guidance and quality reviews covering the materiality of disclosures.
Firm quality reviews	It is good practice for quality reviewers to have sufficient authority, knowledge and experience, as well as a commitment to audit quality. Findings need to be communicated throughout a firm to promote improvements in audit quality for engagements that are not reviewed.
Advice by firms that are not the auditor	A firm should have review processes in place to ensure that advice given to non-audit clients on accounting treatments is appropriate. Inappropriate accounting advice may place pressure on the external auditor to accept an inappropriate treatment.

Remediation

80 Where sufficient appropriate audit evidence has not been obtained, firms should voluntarily remediate deficiencies by obtaining the evidence necessary to support the audit opinion. Otherwise, the audit has not been completed in accordance with the legally enforceable auditing standards and there is a risk that a material misstatement remains undetected.

81 Given the risks associated with not remediating deficiencies, partners and firms should not hesitate to take remedial action because of possible embarrassment in revisiting a client. Firms should have processes in place to require partners to take remedial action. In significant cases, where firms do not accept and implement findings, we will consider issuing an audit deficiency report, or taking court or other regulatory action as needed.

D Areas of future focus

Key points

We will continue to inspect firms that audit significant public interest entities, focusing on entities and industries with perceived heightened risks.

Areas of future focus for firms and our inspections include:

- audit evidence, professional scepticism, and the use of other auditors and experts; and
- the focus areas identified in our six-monthly financial reporting surveillance media releases.

Inspection focus

82 Our audit inspection program will continue to focus on firms that audit entities that are likely to be of significant public interest, and those entities and industries that are more vulnerable to risks arising from existing and emerging market conditions.

83 We will continue to conduct follow-up inspections of firms. Where significant issues have been identified in previous inspections, we will escalate follow-up inspections to ensure that the firms are taking prompt and appropriate action to address our observations and findings.

84 Our reviews of audit files will focus primarily on financial statement audits of listed entities and other public interest entities such as financial institutions and large registered schemes. We will also review a smaller number of compliance plan audits for registered schemes and audits of AFS licensees.

85 In recent years, our inspections have shifted from focusing on processes to assessing the quality of judgements and decisions made by the auditor.

86 We will continue to monitor and examine the causes of recent corporate collapses. Where deficiencies in auditor conduct appear to have contributed to insufficient transparency in the financial position and financial performance of an entity leading up to the collapse, we will focus on these areas in our future audit inspections.

Specific areas of focus

87 Some specific areas of focus for firms and our coming inspections are listed in Table 3.

Table 3: 'Top 10' focus areas

Focus area	Details
Audit evidence	Whether auditors have obtained sufficient appropriate audit evidence to conclude whether the financial report is free of material misstatement and to support their audit opinions.
Professional scepticism	The professional scepticism exercised by auditors, focusing on significant judgements in relation to audit evidence, accounting estimates, going concern and accounting treatments.
Reliance on other auditors and use of experts	The reliance placed on: • the work of other auditors, including in the context of group audits (particularly in connection with business components in emerging markets), interests in joint ventures, and the use of service organisations; and • experts, whether employed or engaged by the audited entity or employed or engaged by the auditor. We will review the processes of a firm's internal specialist groups (e.g. technical accounting, business valuation, treasury, actuarial and taxation) in supporting audit engagement teams and the quality of their advice and judgements.
Financial reporting	Focus areas identified in our six-monthly financial reporting surveillance program media releases.
Fee reductions	Maintaining audit quality for engagements where there have been large fee reductions for new or existing audits without underlying changes to business operations. Attempts to sell additional services to these clients can also raise auditor independence issues. We will review audit files where there have been fee reductions that do not reflect changes in the business of the audited entity. We will also review whether there is evidence that firm leaders have given strong, consistent and genuine messages that, where fees are reduced, audit teams must still perform quality audits.
Audit efficiency measures	Whether audit efficiency measures have led to audit quality being compromised on individual engagements. In addition to our reviews of audit files, we will review whether there is evidence that firm leadership has given consistent and genuine strong messages to partners and staff that improvements in efficiency do not mean compromising on audit quality. We will also consider outcomes from firm quality reviews.
Business models and risk assessments	The adequacy of an auditor's understanding of the business model of the entity and risk assessment for individual engagements, and the auditor's interaction with the audit committee to ensure that key areas of risk are included in the audit strategy.
Supervision and review	The involvement of the engagement partners and EQCRs at all stages of the audit, including planning, and reviewing key judgements and the conclusions reached.
Auditor independence	Compliance with the auditor independence requirements, including: • complying with the auditor rotation requirements of the Corporations Act, including the rotation of EQCRs as they are required to be registered company auditors; and • resisting possible 'opinion shopping', particularly where an audit firm's views are sought on specific accounting treatments before a decision is made about whether to appoint the auditor.
Reporting matters to ASIC	The adequacy and timeliness of auditors reporting suspected contraventions under s311 and 601HG of the Corporations Act, reporting under s990K, and reporting under the national credit legislation.

Appendix: Our inspection approach

Scope of this report

88 Our audit inspection program focused primarily on the review of audits of listed entities and other public interest entities. We also reviewed some compliance plan audits and audits of AFS licensees.

89 This report outlines the results of the inspections of 20 audit firms substantially completed in the 18 months to 30 June 2012. These firms, in aggregate, audit 87% of listed entities by market capitalisation. In the 18-month period to 31 December 2010 (2009–10), we inspected 21 firms.

90 The firms we inspected ranged in size as follows:

(a) Larger National firms—large firms that audit numerous listed entities (more than 5% by market capitalisation) and are national partnerships and members of a global network with multiple offices;

Note: 'Network' is defined in Accounting Professional and Ethical Standard APES 110 *Code of ethics for professional accountants* (APES 110).

(b) Other National and Network firms—firms with national partnerships or individual offices that audit many listed entities and are members of a national or international network; and

(c) Smaller firms—firms that audit a limited number of listed entities and have a small number of partners.

91 A summary of the number of firms we inspected is provided in Table 4.

Table 4: Number of firms inspected

Firms	2011–12	2009–10
Larger national	4	4
Other national and network	6	9
Smaller	10	8
Total	**20**	**21**

Note: All of the Larger National and Other National and Network firms have been inspected more than once. All of the Smaller firms inspected in 2011–12 were inspected for the first time.

92 ASIC has arrangements to assist the Public Company Accounting Oversight Board (PCAOB) of the United States and the Canadian Public Accountability Board (CPAB) with their audit inspections of Australian auditors to ascertain compliance with the relevant requirements in each of those jurisdictions. During 2011–12, three inspections were conducted jointly with the PCAOB and two were conducted jointly with CPAB.

Our inspection process

Larger National and Other National and Network firms

93 We reviewed selected key audit areas in the audit working papers for selected audit engagements. Each review concentrated on the substance of work and on whether sufficient appropriate audit evidence was obtained to support the auditor's conclusions.

94 We focused on key risk areas for each audit. Our procedures are not designed to find minor instances of non-compliance. We challenge engagement partners on the basis on which significant judgements are made.

95 We assess whether each firm's quality control systems comply with ASQC 1, are designed to ensure that audits are performed in accordance with auditing standards, and ensure auditors comply with the auditor independence requirements.

96 During our inspections, we highlighted to each firm suggested areas for improvement.

Smaller firms

97 To reflect the size and client profile of Smaller firms, our inspection approach is limited to:

(a) conducting a review of certain aspects of, generally, one audit file of a listed entity for compliance with the auditing standards; and

(b) holding discussions with leaders, engagement partners and other senior members of the engagement team about the audit file reviewed and certain policies and procedures relating to auditor independence and audit quality in the context of that file.

Audit independence report

98 In July 2012, we issued our final report to the Financial Reporting Council (FRC) of our findings on auditor independence. This report covered the 12 months to 30 June 2012 and is included in the FRC's annual report. As the FRC no longer has responsibility to issue an annual report on such matters, we will report our findings in our future audit inspection reports.

Key terms

Term	Meaning in this document
AASB 101 (for example)	An accounting standard (in this example numbered 101)
accounting standards	Standards made by the Australian Accounting Standards Board under s334 of the Corporations Act
AFS licence	An Australian financial services licence under s913B of the Corporations Act that authorises a person who carries on a financial services business to provide financial services Note: This is a definition contained in s761A of the Corporations Act.
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
APES 110 (for example)	An accounting professional and ethical standard issued by the APESB (in this example numbered 110)
APESB	Accounting Professional and Ethical Standards Board
ASA 200 (for example)	An auditing standard (in this example numbered 200)
ASIC	Australian Securities and Investments Commission
ASQC 1	Auditing standard ASQC1 *Quality control for firms that perform audits and reviews of financial reports and other financial information, and other assurance engagements*
AUASB	Auditing and Assurance Standards Board
auditing standards	Standards made by the AUASB under s336 of the Corporations Act
CGU	Cash generating unit
Clarity auditing standards	Auditing standards revised and redrafted to conform with the 'Clarity' International Standards on Auditing issued by the International Auditing and Assurance Standards Board
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
CPAB	Canadian Public Accountability Board

Term	Meaning in this document
engagement quality control review	A process designed to provide an objective evaluation, before the auditor's report is issued, of the significant judgements the engagement team made and the conclusions they reached in formulating the auditor's report
EQCR	Engagement quality control reviewer
FRC	Financial Reporting Council
Larger National firms	Large firms that audit numerous listed entities (more than 5% by market capitalisation) and are national partnerships and members of a global network with multiple offices
NTA	Net tangible assets
Other National and Network firms	Firms with national partnerships or individual offices that audit many listed entities and are members of a national or international network
PCAOB	Public Company Accounting Oversight Board (US)
s311 (for example)	A section of the Corporations Act (in this example numbered 311), unless otherwise specified
Smaller firms	Firms with a small number of audit partners that audit a limited number of listed entities

Related information

Regulatory guides

RG 34 *Auditor's obligations: Reporting to ASIC*

Legislation

Corporations Act, Pts 2M.3, 2M.4 and 5C.4, Divs 3, 4 and 5, s311, 334, 336, 601HG, 601HG(1), 761A, 913B, 990K

Standards

AASB 101 *Presentation of financial statements*

AASB 136 *Impairment of assets*

APES 110 *Code of ethics for professional accountants*

APES 320 *Quality control for firms*

ASA 200 *Objective and general principles governing an audit of a financial report*

ASA 220 *Quality control for audits of historical financial information*

ASA 230 *Audit documentation*

ASA 240 *The auditor's responsibility to consider fraud in an audit of a financial report*

ASA 250 *Consideration of laws and regulations in an audit of a financial report*

ASA 330 *The auditor's procedures in response to assessed risks*

ASA 500 *Audit evidence*

ASA 505 *External confirmations*

ASA 520 *Analytical procedures*

ASA 530 *Audit sampling*

ASA 540 *Auditing accounting estimates, including fair value accounting estimates and related disclosures*

ASA 550 *Related parties*

ASA 560 *Subsequent events*

ASA 570 *Going concern*

ASA 600 *Using the work of another auditor*

ASA 610 *Using the work of internal auditors*

ASA 620 *Using the work of an expert*

ASQC 1 *Quality control for firms that perform audits and reviews of financial reports and other financial information, and other assurance engagements*

APPENDIX 3

Australian Securities and Investments Commission, Report 242: Audit inspection program public report for 2009-10 (June 2011)

The text of the Australian Securities and Investments Commission, *Report 242: Audit inspection program public report for 2009-10* (June 2011) is attached as Appendix 3.

ASIC
Australian Securities & Investments Commission

REPORT 242

Audit inspection program public report for 2009–10

June 2011

About this report

This report summarises the observations and findings identified by ASIC's audit inspection program in the 18 months to 31 December 2010.

We expect this report to be of significant interest to the inspected firms as well as those we have not inspected, companies, audit committees, the investing public and other interested stakeholders in the financial reporting chain.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Scope/Disclaimer

Sections of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices or conduct of some of the 21 audit firms inspected (firms). The absence of a reference in this report to any other aspect of a firm's systems, policies, procedures, practices or conduct should not be construed as approval by ASIC of those aspects, or any indication that in ASIC's view those aspects comply with relevant laws and professional standards.

In the course of reviewing aspects of a limited sample of selected audit engagements, an inspection may identify ways in which a particular audit engagement is deficient. It is not the purpose of an inspection, however, to review all of the firm's audit engagements or to identify every aspect in which a reviewed audit may be deficient. Accordingly, this report does not provide assurance that the firms' audits, or their clients' financial statements, are free of deficiencies not specifically described in this report.

Unless stated otherwise, not all matters in this report apply to every firm and, where they do apply to more than one firm, there will often be differences in degree. Our observations and findings relate only to the individual firms inspected and cannot be extrapolated across the auditing profession in Australia. Our observations and findings can differ significantly, even between firms of similar size, and for that reason we caution against drawing conclusions about any firms not yet inspected by ASIC.

Unlike some other jurisdictions, ASIC is also the securities regulator in Australia. This report covers inspections but does not include any matters arising from other regulatory activities, such as investigations or surveillance of the firms or their clients, although these matters may inform focus areas in inspections.

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Executive summary

1 This report covers inspections of 21 firms substantially completed in the 18 months to 31 December 2010.

2 Australia's audit regime is similar to the regimes in other major developed countries. However, this report identifies some important audit areas where the firms need to focus their attention and make improvements to ensure audit quality.

3 As a part of our ongoing review of the focuses of our program, and in response to factors such as the global financial crisis and benchmarking with other audit oversight regulators, we increased the number of audit engagement files selected for review at inspections of larger firms in 2009–10. We also reviewed additional key audit areas on each engagement file. These changes would have impacted on the number of findings on each audit file and in each area. A risk-based method was used to select firms, engagement files and audit areas for review.

4 Across the firms inspected, the majority of the engagement files reviewed contained sufficient appropriate audit evidence in key audit areas and audit work in those areas was conducted in accordance with the relevant Australian auditing standards. However, for the large firms 17% of engagement files reviewed did not contain sufficient appropriate audit evidence and for other firms the figure was 31%. Generally where we concluded that audit engagement files did not contain sufficient appropriate audit evidence, this was based on shortcomings identified for specific areas of the audit. Overall, we identified three broad areas where improvements need to be made by the firms. Many of the observations and findings in this report relate to shortcomings in the areas of:

(a) the sufficiency and appropriateness of audit evidence on engagement files. The evidence should support the audit opinion by clearly demonstrating the auditor's procedures and conclusions on key audit judgement or risk areas. Areas where improvements are required include when relying on the work of experts or other auditors, confirmation of key balances, classification of material loan balances, consideration of the risk of fraud, and financial statement disclosures;

(b) the level of professional scepticism exercised or evidenced on the engagement files by auditors in key areas of audit judgement, including fair value measurement of assets, impairment calculations, going concern assessments and other fundamental areas of the audit; and

(c) the lack of evidence on audit engagement files about the nature, timing and extent of engagement quality control reviews.

5 To further enhance audit quality and to ensure that the auditors' judgements are robust and well supported, leaders of firms should continue to send strong and consistent messages to partners and staff about the importance of these three areas. It is important that these messages continue to be complemented by education and training, firm guidance, effective technical support and internal monitoring.

6 Firms we have previously inspected continued to maintain or improve their quality control systems to facilitate compliance with the requirements of the *Corporations Act 2001* (Corporations Act), Australian auditing standards, and Australian professional and ethical standards. This demonstrates the firms' commitment to high quality audits and auditor independence, and the continued positive impact of our inspection program.

7 The extent of quality control systems varies between firms due to their size and structure. Aspects of some firm quality control systems can be improved to comply with legal and professional requirements: see Section D.

8 Future focus areas for firms are highlighted in Section E. We will continue to inspect firms that audit significant public interest entities, monitor regulatory developments in auditing and collaborate with foreign regulators to minimise the regulatory burden on Australian firms.

A Overview of the inspection process

Key points

The aim of ASIC's audit inspection program is to promote high quality external audits of financial reports of listed entities and other public interest entities so that users can have greater confidence in these financial reports and Australia's capital markets.

During this inspection cycle, we increased the number of audit engagement files reviewed at inspections of larger firms, reviewed additional key audit areas, reviewed some fundamental audit procedures and reviewed audit areas that were identified as potential risk areas in the future focus section of our last public report.

This is the fifth public report on our audit inspection program. The report outlines the results of the inspection of 21 audit firms substantially completed in the 18 month period from 1 July 2009 to 31 December 2010.

As ASIC is both an audit oversight regulator and a securities regulator, in addition to audit inspections we conduct a range of other activities that cover the work of the firms. This report covers the results of our audit inspection program only and does not include any matters arising from our other regulatory activities.

Objectives of the audit inspection program

9 A strong audit profession helps maintain and promote confidence and integrity in Australia's capital markets. The aim of ASIC's audit inspection program is to promote high quality external audits of financial reports of entities listed on the Australian Securities Exchange (ASX) or other Australian exchanges (listed entities) and other public interest entities in accordance with Ch 2M of the Corporations Act so that users can have greater confidence in these financial reports.

10 Our audit oversight activities help maintain and raise the standard of conduct in the auditing profession. We focus on audit quality and promoting compliance with the requirements of the Corporations Act, Australian auditing standards, and Australian accounting professional and ethical standards (issued by the Accounting Professional and Ethical Standards Board (APESB)).

11 Any improvement areas identified through the inspection program about compliance with Australian auditing standards or other requirements, and best practice enhancements, are included in a private individual report to each firm and they are responsible for addressing these areas. The purpose of the inspection program is not to benchmark firms.

12 While our inspection program has an education and compliance focus, enforcement action may be taken where significant non-compliance is identified. Such enforcement actions are outside the scope of the audit inspection program and are referred to ASIC's Deterrence teams for further consideration and action.

Changes to the audit inspection program

13 Our audit inspection program focuses on reviewing the firms' quality control systems and examining aspects of a sample of the firms' individual audit and review engagement files to assess audit quality. Each year we conduct follow up inspections of firms we had previously visited and, on each occasion, we identify fewer deficiencies in the firm quality control systems or areas that require improvement.

14 As most of the larger firms that audit the majority of the listed entities have sound and well established quality control systems, we changed the approach of the inspection program to focus on significant changes to these systems. This enabled us to devote more time to the assessment of audit quality at the firms through engagement file reviews.

15 The key changes to our 2009–10 inspection program included:

(a) significantly increasing the number of audit engagements selected for review to 131, compared to 101 in the previous 18 month period to 30 June 2009 (see Figure 1);

(b) reviewing a greater number of key audit areas in more depth on each engagement file;

(c) on each engagement file, reviewing a fundamental audit area. That area may have been identified as potential risk from our recent reviews of corporate collapses, results of other investigations or findings about Australian auditing standards that had been previously poorly applied by the firms;

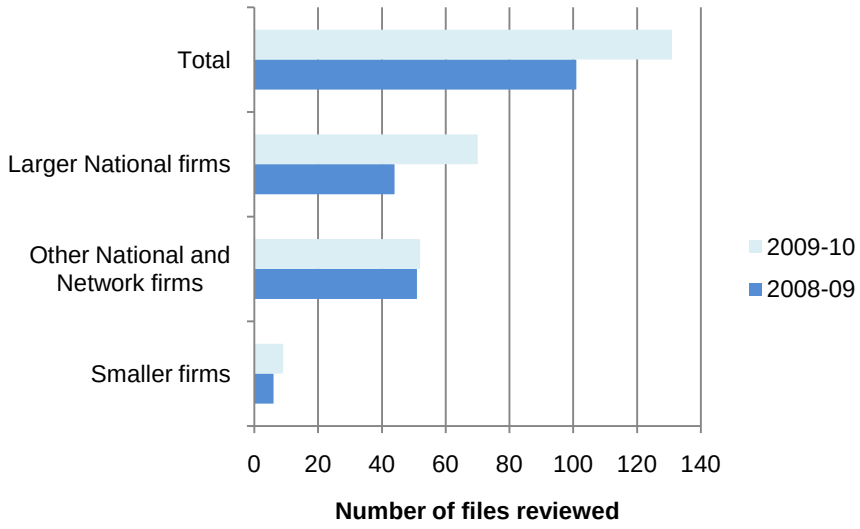
(d) in some cases reviewing an engagement file from cover-to-cover;

(e) extending the period of the on-site inspection at the firms to facilitate the above changes; and

(f) enhancing the structure and content of our private inspection reports to firms to include best practice considerations, suggested remedial actions and the firms' responses to our observations and findings.

16 We also benchmarked our inspection process with those of other international jurisdictions that have independent audit inspection programs and, where appropriate, enhanced our inspection approach to ensure we continue to apply best practice.

Figure 1: Number of engagement files reviewed



17 The appendix contains further details about how we conducted our work.

Scope of this report

18 This is the fifth public report on our audit inspection program since the enactment of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9 Act) on 1 July 2004.

19 As ASIC is both an audit oversight regulator and a securities regulator, in addition to audit inspections we conduct a range of other activities that relate to the work of the firms. These other activities include our financial reporting surveillance program, surveillances of individual audits and investigations into corporate failures. While these activities inform our areas of focus and determine the frequency of future audit firm inspections, this report covers the results of our audit inspection program only and does not include any matters arising from our other regulatory activities.

20 This report outlines the results of audit inspections substantially completed in the 18 month period from 1 July 2009 to 31 December 2010. During that period we inspected 21 audit firms (firms) that, in aggregate, audit 87% of listed entities by market capitalisation. In the prior 18 month period from 1 January 2008 to 30 June 2009 (2008–09) we inspected 19 firms.

21 The firms inspected range in size as follows:

(a) large firms that audit numerous listed entities (more than 5% by market capitalisation) and are national partnerships and members of a global network[1] with multiple offices (Larger National firms);

(b) firms with national partnerships or individual offices that audit many listed entities and are members of a national or international network (Other National and Network firms); and

(c) firms that audit a limited number of listed entities and have a small number of partners (Smaller firms).

22 A summary of our inspection of the firms is provided in Table 1.

Table 1: Summary of firms inspected

Firms	2009–10 Total inspected	2008–09 Total inspected
Larger National	4	4
Other National and Network	9	9
Smaller	8	6
Total	21	19

Note: In 2009–10, two Other National and Network firms and all of the Smaller firms were inspected for the first time. Each of the Larger National firms has been inspected more than once.

23 During 2008–09, our inspection approach for Other National and Network firms changed from reviewing an individual office of a network to reviewing a number of the member firms of the network at each inspection. We continued this approach during the 2009–10 inspections. Other National and Network firms visited for the first time were subject to a full-scope inspection comprising the review of network-wide quality control systems and review of a sample of individual audit engagements from various offices within that network.

24 Larger National firms and Other National and Network firms that we inspected previously were subject to a subsequent review inspection. The scope of a subsequent inspection consists of following up matters noted in prior inspection reports, reviewing significant changes to the firms' quality control systems, limited testing of those systems and reviewing a sample of individual audit engagement files.

[1] Network is defined in Accounting Professional and Ethical Standard APES 110 *Code of Ethics for Professional Accountants* (APES 110).

25 Smaller firms are subject to a limited scope inspection due to the size, client profile and nature of these firms. The inspection of a Smaller firm generally involves reviewing one listed entity audit engagement file and enquiring about the key features of the firm's quality control systems as they relate to that engagement.

26 Our review of aspects of a sample of audit engagement files at the firms had regard to the Australian auditing standards that were in force at the time. The Australian auditing standards were reissued in October 2009 as part of the 'Clarity' project, to present them in a clearer format. However, the Clarity auditing standards are applicable for audits of financial reports for periods commencing on or after 1 January 2010 and, therefore, did not apply to audits that were within the scope of the audit inspection program for 2009–10.

27 ASIC has an arrangement with the Public Company Accounting Oversight Board (PCAOB) of the United States to assist the PCAOB with their audit inspections of Australian auditors to ascertain compliance with the *Sarbanes-Oxley Act 2002* (US) (Sarbanes-Oxley Act (US)). During 2009–10, four inspections were conducted jointly with the PCAOB. Where the timing of the PCAOB and ASIC audit inspections did not coincide we were able to share our private firm inspection reports with the PCAOB to assist them in their oversight function, in accordance with the confidentiality requirements of the *Australian Securities and Investments Commission Act 2001* (ASIC Act).

B Major findings

Key points

In this cycle of audit inspections, the firms we had inspected previously continued to maintain or improve their quality control systems, demonstrating their commitment to high quality audits. The level of engagement and responsiveness by the firms to our observations and findings demonstrates the positive impact of our audit inspection program.

The three broad areas where the firms need to make improvements to further enhance audit quality are:

- the quality of audit evidence on engagement files to corroborate the auditor's conclusion on key judgement areas;
- the level and attitude of professional scepticism exercised or demonstrated by auditors; and
- the lack of evidence on engagement files to demonstrate the involvement of the engagement quality control reviewer (EQCR) during the engagement.

We also continue to have concerns about shortcomings in the independence systems of some of the firms and, in particular, about contraventions of the independence requirements of the Corporations Act.

Impact of the audit inspection program

28 In this cycle of audit inspections, the firms we had inspected previously continued to maintain or improve their quality control systems, demonstrating their commitment to independence and high quality audits. However, there are still a number of important audit areas where the firms should give continued focus and attention and make further improvements.

29 The firms have implemented quality control systems to ensure compliance with the independence requirements of the Corporations Act and professional quality control and ethical standards. Although the extent and complexity of these systems varies depending on the size and nature of the firm, the implementation of quality control systems demonstrates that the firms understand their obligation to comply with these requirements.

30 Since the commencement of our audit inspection program we have inspected all Larger National firms and Other National and Network firms once, with a large number of these firms being inspected more than once. We have also made good progress in inspecting Smaller firms over the last three years.

31 The results of our first inspection of a firm often indicate that some aspects of quality control have not been addressed or fully developed. Subsequent

inspections of a firm almost always show a marked improvement in most, if not all, areas identified in the first inspection. This indicates that the firms recognise the importance of our inspection program in promoting high quality external audits.

32 Our inspection program provides an objective assessment of the quality of audits conducted. The firms and ASIC have a common objective to enhance audit quality. The firms have generally been cooperative and receptive to our observations and findings, and suggested remedial actions, demonstrating the positive impact of our audit inspection program.

Major findings: Audit quality

33 As a part of our ongoing review of the focuses of our program, and in response to factors such as the global financial crisis and benchmarking with other audit oversight regulators, we increased the number of audit engagement files selected for review at inspections of larger firms in 2009–10. We also reviewed additional key audit areas on each engagement file. These changes would have impacted on the quantity of findings on each audit file and in each area.

34 Our review of individual audit engagements informs our assessment of audit quality at the firms. We focus our reviews on aspects of the engagement files that contribute to safeguarding and enhancing audit quality. In 2009–10 we paid particular attention to those key audit areas most affected by the global economic downturn and identified a number of audit areas that need to be improved by all the firms. The majority of the engagement files reviewed contained sufficient appropriate audit evidence in key audit areas and audit work in those areas was conducted in accordance with the relevant Australian auditing standards. Generally where we concluded that audit engagement files did not contain sufficient appropriate audit evidence, this was based on shortcomings identified for specific areas of the audit. We identified three broad areas where improvements need to be made by the firms (as outlined in paragraphs 35–48). While there may be differences in the size and structure of the firms, and variation in the conduct of an audit by the different firms, the overall themes from the review of the firms' engagement files is not markedly dissimilar.

Quality of audit evidence

35 We continue to have concerns about the quality (sufficiency and appropriateness) of audit evidence on the engagement files to corroborate the auditor's conclusions on key judgement and risk areas. In many instances, these areas included areas affected by the global economic downturn. Our review of approximately 32 of the 131 audit engagements resulted in

numerous concerns about the adequacy of evidence to corroborate the auditor's work or conclusions in key areas, including:

(a) fair value measurement and impairment calculations;

(b) classification of material loan balances;

(c) consideration of the risk of fraud; and

(d) assessment of the competence and the work of experts engaged by clients.

36 In past reports we accepted that there may be cases where the necessary audit evidence was obtained and appropriate consideration was given to significant judgement areas, but this was not documented. However, in the absence of adequate documentation on the engagement files, it can be difficult to assess whether sufficient appropriate audit evidence was gathered, and whether the requirements of the Australian auditing standards were complied with, even allowing for oral explanations provided by the auditor about the audit work performed and evidence obtained. Therefore, if there is no documentation on the engagement file, the presumption must be that the auditor did not obtain the necessary audit evidence.

37 Audit engagement files need to contain sufficient appropriate evidence to reduce the risk that the auditor's procedures or conclusions on key judgement areas, and ultimately the auditor's report, could be challenged. In particular, the engagement file should contain evidence of the nature, extent and timing of procedures performed over specific audit assertions about key account balances in the financial report. To ensure that engagement files and the auditor's judgements are supported, the leaders of the firms should send strong and consistent messages about the importance of sufficient and appropriate audit evidence and reinforce this through training and effective internal monitoring programs.

Professional scepticism

38 Our audit inspection program has identified a number of instances where we have concerns about the auditors' judgement, and the level and attitude of professional scepticism. Auditing Standard ASA 200 *Objective and General Principles Governing an Audit of a Financial Report* (ASA 200) defines professional scepticism as 'an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence'.

39 An auditor is required to plan and perform an audit with an attitude of professional scepticism. An attitude of professional scepticism is critical in assessing evidence in routine areas of the audit, such as classification of material loan balances and reasons for large variances in analytical review procedures.

40 This scepticism should be heightened particularly when assessing evidence in areas that involve significant estimation or judgement by clients (such as asset valuation and impairment calculations, and when considering the appropriateness of a client's accounting treatments or the going concern assumption).

41 Our review of audit engagements has found instances where auditors:

(a) appear to have been over reliant on a client's explanations and representations (especially about fair value measurement, going concern assumptions and analytical review procedures);

(b) have not explored evidence available on other parts of the engagement file that appears inconsistent or contradictory; and

(c) have not had sufficient regard to historical outcomes in assessing the reasonableness of assumptions underlying the client's decisions (especially about optimistic cash flow projections, growth rates and discount rates for impairment testing).

42 In addition, we found instances where auditors have approached highly judgemental and subjective balances by seeking to obtain audit evidence that corroborates rather than challenges the client's judgments.

43 In some key audit areas that involve judgement it is necessary at times to rely on evidence that is persuasive rather than conclusive. Consequently, it is crucial that audit engagement files contain sufficient appropriate evidence to demonstrate the extent of professional scepticism exercised by the auditor. A lack of documentation to evidence the exercise and extent of professional scepticism by engagement partners and teams could lead to potential concerns relating to the objectivity and quality of audit work undertaken.

44 An attitude of professional scepticism is a critical part of conducting quality audits. Therefore, a culture of professional scepticism needs to be supported and promoted through robust messages from leaders of the firms and complemented by education and training, firm guidance and procedures, effective technical support and engagement quality control reviews.

Engagement quality control reviews

45 The role of an engagement quality control reviewer (EQCR) is to objectively evaluate, before an audit report is issued, the work done and conclusions reached by the audit engagement team in significant judgement and risk areas. The engagement quality control review is a critical element of quality control and contributes to achieving audit quality. To ensure this quality control function is effective, it is essential that the EQCR is involved throughout the audit process.

46 Most firms have policies on the EQCR's role and responsibility. Despite this, we noted deficiencies in the engagement quality control review in our previous public reports. We continue to be concerned that there are numerous findings from the 2009–10 audit inspection program about:

(a) the lack of documented evidence on audit engagement files demonstrating the involvement of the EQCR during the engagement; and

(b) the relatively low levels of time recorded by the EQCR for the engagement.

47 To further enhance quality of an audit, the EQCR's evaluation of the work performed and conclusions reached by the engagement team on significant judgement and risk areas needs to be sufficiently and appropriately evidenced on the engagement file. The leaders of the firm need to reinforce this to engagement partners and EQCRs.

48 Detailed observations about our major findings relating to audit quality are set out in Section C.

Major findings: Quality control

49 Due to the difference in the size and structure of the firms, quality control systems will vary in sophistication and maturity. Generally, there are few, if any, findings in this area for the Larger National firms. Other National and Network firms that have been inspected more than once generally made improvements to their quality control systems, so there were fewer findings at these firms than those inspected for the first time. However, we continue to have concerns about the number of findings at many firms about independence processes and, in particular, about contraventions of the rotation and independence requirements of the Corporations Act.

50 Independence is fundamental to the conduct of a quality audit. Leaders of the firms need to ensure that they give strong and clear messages about the importance of independence to set an appropriate 'tone at the top'. Where relevant, the firm should take appropriate action against personnel that contravene the independence requirements of the Corporations Act and the firm's own independence policies.

51 Smaller firms need to continue to develop and implement many aspects of their quality control systems—in particular, systems to enable compliance with the independence requirements of the Corporations Act. In addition, Smaller firms require continued development of their systems relating to ethical and professional standards, and procedures to systematically and rigorously examine and monitor audit quality.

52 In June 2010, ASIC issued a report about auditor independence to the Financial Reporting Council (FRC) in accordance with our Memorandum of Understanding with them. This report, which is provided annually to the FRC, includes more detail on our findings on auditor independence and is included in the FRC's 2009–10 annual report.[2]

53 Detailed observations about our major findings relating to quality control are set out in Section D.

[2] *Annual report 2009–10*, Financial Reporting Council, 11 October 2010, www.frc.gov.au/reports/2009_2010/downloads/FRC_AR_2009-10.pdf.

C Detailed observations and findings: Audit quality

Key points

All the firms need to improve audit quality on engagements by ensuring that:

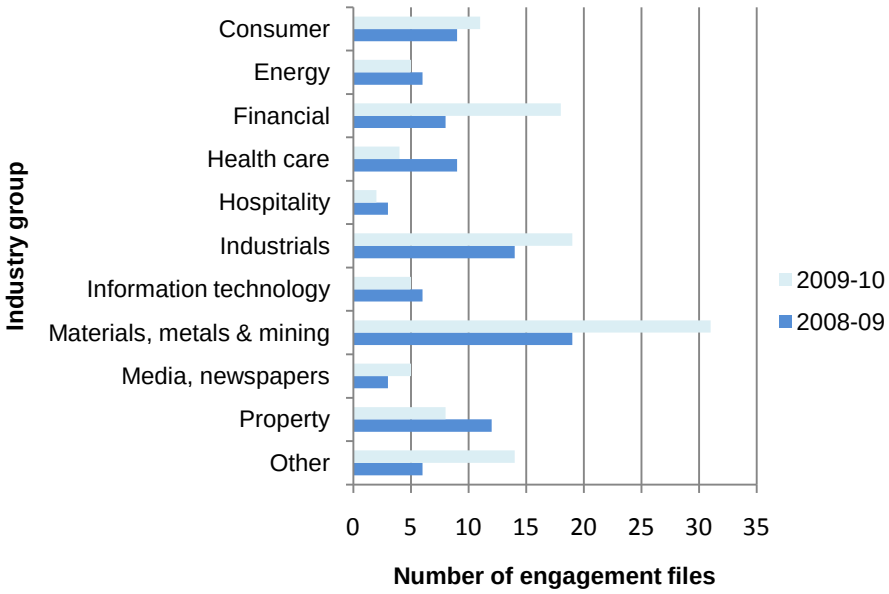
- engagement files contain sufficient appropriate audit evidence. The evidence should support the audit opinion by clearly demonstrating the auditor's procedures undertaken and conclusions on key audit judgement or risk areas. Areas where improvements are required include reliance on the work of experts or other auditors, consideration of the risk of fraud, and the audit of financial statement disclosures, including classification of material loan balances;
- auditors exercise professional scepticism in the key areas of audit judgement, including fair value measurement of assets, impairment calculations, going concern assessments and other fundamental areas of the audit; and
- that the nature, timing and extent of the engagement quality control review is adequate.

Larger National and Other National and Network firms

54 We reviewed aspects of 122 audit engagements files[3] across the Larger National firms and the Other National and Network firms over the 18 month period to 31 December 2010. In a small number of these files, we conducted a cover-to-cover review considering all aspects of the audit process. Our file selections were spread across a range of sectors (see Figure 2) with financial reporting periods ended between 30 June 2008 and 30 June 2010 (10% were 30 June 2008, 57% were 30 June 2009, 29% were 30 June 2010 and 4% were other year ends). We selected the files based on a number of factors, including entities or industries perceived to be at heightened risk as a result of the global economic downturn, audit engagements where there were substantial reductions in audit fees, and entities or industries identified in other ASIC activities.

[3] During the period covered by the previous inspection report, we reviewed aspects of 88 audit and seven review engagements across the Larger National and Other National and Network firms.

Figure 2: Number of engagement files reviewed by industry group



55 As a part of our ongoing review of the focuses of our program, and in response to factors such as the global financial crisis and benchmarking with other audit oversight regulators, we increased the number of audit engagement files selected for review at inspections of larger firms in 2009–10. We also reviewed additional key audit areas on each engagement file. These changes would have impacted on the quantity of findings on each audit file and in each area. A risk-based method was used to select firms, engagement files and audit areas for review.

56 The majority of the engagement files reviewed contained sufficient appropriate audit evidence to support the conclusions reached and demonstrate that the audit was conducted in accordance with the relevant Australian auditing standards. However, for the Larger National Firms, 17% of engagement files reviewed did not contain sufficient appropriate audit evidence. For Other National and Network Firms this figure was 29%. Generally where we concluded that audit engagement files did not contain sufficient appropriate audit evidence, this was based on shortcomings identified for specific areas of the audit. We identified three broad areas where improvements need to be made by the firms and these are detailed in paragraphs 61–121.

57 The objectives of the review of engagement files were to assess the practical application of the audit methodologies of the Larger National firms and Other National and Network firms, and consider whether the key matters that contribute to the audit opinion had been adequately addressed by the engagement team. Our reviews were not designed to detect all instances of non-compliance or to confirm all aspects of the audit opinion.

58 Our review of the engagement files focused on the substance of the auditors' work, to assess if there was sufficient appropriate audit evidence on the file to support the key audit considerations and the conclusions of the auditor on significant judgement areas; in particular, the areas affected by the global economic downturn.

59 There are differences in the size, structure and extent of centralised resources, the international reach, and the risk management strategies among the Larger National and Other National and Network firms. While there may be variations in the conduct of audits by the different firms, the overall themes from the review of the 122 audit engagements was not markedly different. Consequently, we have not reported separately the findings relating to Larger National firms and those relating to Other National and Network firms.

60 During 2009–10, we provided private reports separately to each of the firms on the findings from our reviews. In some cases where our findings at a firm were systemic or considered to be more serious, we accelerated our subsequent inspections to ensure that corrective actions taken by the firms were adequate.

Common observations and findings

61 Most of the engagement files reviewed contained sufficient appropriate audit evidence to support the conclusions reached and demonstrate that the audit was conducted in accordance with the relevant Australian auditing standards. However, we are concerned that there are several important findings common to the Larger National and Other National and Network firms that we reported on in 2008–09 and which we observed again in 2009–10. Shortcomings in the areas detailed in paragraphs 62–121 can have an adverse impact on the quality of the audit that is conducted and potentially the reliability of the auditor's report.

Audit evidence and documentation

62 The Corporations Act requires audits to be conducted in accordance with the Australian auditing standards. Auditing Standard ASA 500 *Audit Evidence* (ASA 500) requires the auditor to obtain sufficient appropriate audit evidence[4] to be able to draw reasonable conclusions on which to base their opinion. Auditing Standard ASA 230 *Audit Documentation* (ASA 230) requires the auditor to prepare, on a timely basis, audit documentation that provides a sufficient and appropriate record of the basis for the auditor's

[4] 'Sufficiency' is the measure of the quantity of audit evidence obtained, while 'appropriateness' refers to the measure of the quality of the audit evidence (i.e. its relevance and reliability in providing support for the classes of transactions, account balances, disclosures and related assertions). A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others.

report and evidence that the audit was performed in accordance with Australian auditing standards and applicable legal and regulatory requirements. If the evidence of the work done is not documented, it is difficult to ascertain what audit procedures the auditor performed to reach a conclusion and whether the auditor complied with the requirements of the Australian auditing standards.

63 Audit evidence and documentation deficiencies are pervasive across most of the areas noted in this section.

64 In a number of engagement files, the deficiencies related to sufficiency and appropriateness of evidence obtained to form conclusions about audit assertions for key areas or insufficient documentation of the audit procedures performed. In addition, we noted a small number of instances of incomplete or late assembly of engagement files. In these cases, there is a risk that the audit work was not adequately performed and that the conclusions reached were not appropriate at the time that the audit report was issued.

65 In the majority of cases, the auditors provided oral explanations to us that the audit work had been performed but not documented. Accordingly, the firms often concluded that many of the deficiencies we identified on the engagement files about insufficient audit evidence were simply a lack of documentation. However, we did not always concur with the firms' conclusions. Paragraph 13 of ASA 230 states that 'ordinarily, oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation'.

66 Our inspections also found instances where the auditor relied upon evidence that was not appropriate for providing the assurance required to reduce the risk of material misstatements for specific assertions to an acceptably low level. In these cases, there is a risk that the conclusions formed by the auditor are not properly supported by the evidence on the engagement file or a material misstatement is not identified or adequately addressed.

67 To comply with the requirements of ASA 500, auditors must have sufficient and appropriate audit evidence on the file and design procedures around specific audit assertions that reduce the risk of a material misstatement. In accordance with ASA 230, the engagement file must contain sufficient and appropriate documentation to enable an experienced auditor with no previous connection with the audit to understand audit procedures performed, the results of those procedures and the audit evidence obtained to support the audit conclusions reached.

Relying on the work of experts

68 Clients of the firms often rely on experts to assist with specialised areas of financial reporting, including asset valuations. The experts can be either individuals employed directly by the client or external experts engaged by the client to provide the specialised service.

69 Auditing Standard ASA 620 *Using the Work of an Expert* (ASA 620) requires an auditor to obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purpose of the audit. The auditor is also required to evaluate the expert's competence and objectivity. The risk that an expert's objectivity may be impaired increases where the expert is employed by the client.

70 In some of the engagement files where an expert was used by the client, there was insufficient evidence to demonstrate that the auditor assessed the professional competence and objectivity of the expert and the appropriateness of the expert's work as audit evidence.

71 In the majority of the instances where there was insufficient evidence of the auditor's assessment of the expert's competence or objectivity, the expert was an external specialist engaged by the client. We were often advised by the auditor that, as the expert was well known in the relevant industry or provided services to other major entities in the industry, their assessment of the expert's credentials and objectivity was not documented.

72 The auditor must include sufficient documentation on the engagement file to enable an experienced auditor with no previous connection with the audit to understand the nature, timing and extent of the procedures performed to evaluate the competence and objectivity of an expert engaged by a client. Ordinarily, oral explanations on their own do not represent adequate support for the conclusions reached by the auditor.

73 In a small number of instances the expert the client relied on was an internal employee of the client. While in some cases there was evidence the auditor assessed the professional competence of the employee providing the expert advice, there was no evidence that the auditor assessed the risk that the expert's objectivity could have been impaired—for example, due to being financially reliant on the client. In addition, we did not see evidence of the auditor's consideration of whether the client should have, perhaps on a cyclical basis, engaged an external expert to corroborate the work of the internal expert.

74 In the cases where an external expert was engaged by the client, in a small number of instances the engagement file did not contain sufficient evidence that the auditor assessed the reasonableness of the assumptions used by the expert and whether the work performed by the expert was adequate for the

purposes of forming appropriate evidence to support the audit assertion being considered by the auditor.

75 Given the level of estimation and judgement involved in valuing assets, even when undertaken by specialists, we would have expected to see evidence of a heightened level of professional scepticism by the auditor, particularly where reliance is placed on the client's internal expert.

Using the work of other auditors

76 Auditing Standard ASA 600 *Using the Work of Another Auditor* (ASA 600) requires the principal auditor, when planning to use the work of another auditor, to consider the professional competence of the other auditor. In addition, the principal auditor should perform procedures to obtain sufficient appropriate evidence that the work of the other auditor is adequate for the purposes of the principal auditor. This might require the principal auditor to advise the other auditor of the relevant independence requirements, the use to be made of the other auditor's work and matters requiring special consideration. This is often achieved by the principal auditor issuing instructions to the other auditor.

77 The other auditor can be another auditor in the same network as the principal auditor or may be an unrelated auditor. The requirements of ASA 600 apply to both an auditor in the same network and an unrelated auditor.

78 In some of the engagement files where other auditors were utilised we found instances where, although the principal auditor placed reliance on the work of another auditor, the engagement file did not contain sufficient evidence that the principal auditor:

(a) issued specific instructions to the other auditor;

(b) assessed the professional competence and/or independence of the other auditor; or

(c) considered the appropriateness of the work performed by the other auditor, including:

  (i) assessing if materiality levels used by the other auditor were appropriate;

  (ii) evaluating whether significant matters noted by the other auditor had been addressed; and/or

  (iii) reviewing that the work done by the other auditor was in accordance with the instructions issued.

79 In some of these cases, where the auditor advised that they visited the operations of overseas subsidiaries, held meetings with the other auditors or reviewed the other auditor's working papers, evidence of this was not sufficiently documented on the audit engagement files.

80 In the majority of these cases the other auditor was part of the principal auditor's network. Nevertheless, it is still necessary for the principal auditor to appropriately consider the independence and competence of the other auditor and evaluate the work done by the other auditor. This is particularly important where the other auditor is part of a firm in a network in another country where there may be limited regulatory oversight of auditors and a different culture within that firm.

81 In a small number of these instances the other auditor was not part of the principal auditor's network. This raises concerns about how the principal auditor was able to place reliance on the work of the auditor given there was insufficient evidence on the engagement files to show that the principal auditor:

(a) appropriately assessed the competence and independence of the other auditor;

(b) issued specific instructions; and/or

(c) adequately reviewed the work of the other auditor.

82 ASA 600 has been substantially revised as part of the Clarity auditing standards. While not applicable for the period under review, the new standard makes it clear that the group engagement partner is responsible for the direction, supervision and performance of the group audit and ensuring that sufficient appropriate audit evidence is obtained, regardless of who performs the work. The principal auditor needs to be adequately involved in the work of the other auditor throughout the engagement. We will focus on the application of this standard in our future inspections.

Consideration of the risk of fraud

83 Auditing Standard ASA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report* (ASA 240) requires the auditor to consider the risks of material misstatement in the financial report due to fraud.

84 A number of the engagement files reviewed did not contain sufficient evidence of the auditor's consideration of fraud. In most of these instances, there was no evidence that the engagement team discussed the susceptibility of the entity's financial report to material misstatement due to fraud. While the auditor provided an oral explanation that the possibility of fraud was discussed by the engagement team, this was not sufficiently documented in the engagement file.

85 In one instance, there was no evidence that fraud was specifically discussed by the auditor, when gaining an understanding of the entity, with either management or those charged with the governance of the entity. The lack of sufficient documentation of discussions about the risk of fraud does not comply with the documentation requirements of ASA 230 and also

ASA 240, which has specific documentation requirements for fraud assessment.

External confirmations

86 ASA 500 sets out how the reliability of audit evidence is influenced by its source and nature. Evidence is more reliable when it is obtained from independent sources outside the entity. It is a generally accepted audit practice that independent confirmations should be obtained for material and/or significant balances (such as cash at bank, investments, and loans with financial institutions and debtors) to support the accuracy, existence and/or completeness audit assertions.

87 In a small number of engagement files the auditor did not request external confirmations for significant financial statement balances. In addition, those files did not always contain an adequate explanation of why external confirmation requests were not sent by the auditor.

88 Where external confirmations are not obtained, the auditor is required to perform alternative procedures that will provide sufficient appropriate audit evidence about the audit assertions that the confirmation was intended to cover. In some instances, the alternative procedures performed did not, in our view, provide sufficient appropriate evidence to support the key assertions of existence and completeness of the significant balances. For example, documents faxed directly to the client by the financial institution are not a substitute for confirmations obtained directly by the auditor from a financial institution.

89 The failure to obtain an independent confirmation of a significant balance brings into question how the auditor gained the audit assurance required to reduce the risk of a material misstatement to an acceptably low level to conclude that the financial statements were presented correctly.

Classification of loans

90 The classification of loan balances has been an area of our focus in this cycle of inspections. The global economic downturn could seriously affect the ability of an entity to refinance debt. The classification of loan balances is important to understanding the financial position of an entity and we have highlighted it as a financial reporting finding in recent years.

91 Australian accounting standard AASB 101 *Presentation of Financial Statements* (AASB 101) requires entities, when presenting information in financial reports, to disclose liabilities as current (due and payable within 12 months) or non-current (due and payable later than 12 months). This information is useful for users of a financial report to assess the liquidity and solvency of an entity. We found that in a small number of engagement files

there was insufficient evidence of the procedures undertaken by the auditor in relation to the client's classification of loan balances.

92 In many instances, the auditor provided oral explanations of the work done to verify the classification of loans. However, in all of these cases the audit procedures undertaken were not adequately documented on the engagement file. Some engagement files did not contain sufficient evidence to show procedures undertaken by the auditor to verify the client's compliance with complex loan covenants, or whether internal technical or legal consultations were undertaken on complex loan covenants and agreements.

93 In some of these engagement files there was insufficient evidence to demonstrate the auditor exercised professional scepticism in assessing the appropriate classification of material loan balances. These engagement files did not contain evidence that the auditor critically examined the evidence provided by the client with a questioning mind, and there was no evidence that the auditor challenged the client's assertions about the repayment of the debt in light of other evidence that was available to the auditor.

Financial statement disclosures

94 Auditing Standard ASA 330 *The Auditor's Procedures in Response to Assessed Risks* (ASA 330) requires the auditor to perform audit procedures to evaluate whether the overall presentation of the financial report, and the disclosures therein, is in accordance with the applicable financial reporting framework.

95 In some cases, we found incorrect or inadequate disclosures in the financial reports of the entities audited, particularly in the notes to the financial statements. In these cases, there was no evidence on the engagement file that the auditor complied with the requirements of ASA 330. In many instances, oral explanations were provided to us by the auditors that the disclosure deficiencies were not considered to be material.

96 In some of these instances, there was insufficient evidence on the engagement file to demonstrate that the auditor had adequately:

(a) reviewed the notes to the financial statements;

(b) assessed the information in the notes in light of the audit procedures undertaken; and

(c) challenged the assertions or representations of the client about the financial statement disclosures.

97 In such circumstances, in the absence of sufficient evidence to the contrary, it is unclear whether the auditor performed detailed audit procedures to assess the accuracy of some key disclosures and consulted with internal accounting specialists about specific disclosure requirements of Australian accounting standard. Examples of disclosure deficiencies included

disclosures related to fair value measurement, impairment testing (see paragraph 110) and segment reporting.

98 As set out in AASB 101, the notes to the financial statements are part of a complete financial report and the objective of financial reports is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. In light of this, we would expect auditors to assign appropriate importance to reviewing financial report disclosures.

Technical consultations

99 To manage the risks associated with auditing during the global economic downturn, many of the firms increased their requirements for engagement teams to consult with internal technical specialists about complex audit areas such as fair value measurements, review of impairment calculations and the appropriateness of going concern assumptions. The majority of the Larger National and Other National and Network firms have policies about such technical consultations.

100 In some of the engagement files there was insufficient evidence about the engagement team's consultations on complex or specialist areas with the firm's internal technical specialists.

101 In the majority of these instances, the evidence on the engagement file was not sufficient to demonstrate the extent and nature of discussions between the engagement team and the firm's internal technical specialists. In particular, the evidence did not clearly describe the role or the work performed by the firm's internal technical specialists. In those circumstances, it was difficult to assess whether the engagement team was able to rely on the results of the technical consultations.

102 In the future we will extend the focus of our inspections to the operation of the firm's internal technical specialist groups in supporting audit judgements, including a review of the relevant quality control systems within these groups.

Professional scepticism

103 ASA 200 requires an auditor to plan and perform an audit with an attitude of professional scepticism. Professional scepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of the audit evidence obtained and the client's judgements on accounting treatments and estimates. In many of the engagement files there was insufficient evidence that the auditor exercised an attitude of professional scepticism and objectively assessed the evidence presented by clients and client judgements.

104 A questioning mind and objective approach to assessing evidence is critical where entities are required to make estimates and/or judgements in significant and material areas of a financial report. In many engagement files, at least one of our observations related to fair value measurements, impairment calculations and going concern assessments where, in our view, the auditor did not demonstrate adequate professional scepticism. In a number of these instances, we were concerned by the lack of evidence that the auditor clearly challenged the client; it instead appeared that the auditor sought out evidence to corroborate what they were told by the client.

Fair value measures and impairment

105 Given that the global economic downturn increased the likelihood that the value of assets could be impaired, we paid particular attention in our inspections to the key audit areas of measuring the fair value of assets and the associated audit procedures performed on asset impairment calculations.

106 It is the responsibility of an entity to determine if the value of an asset may be impaired and then to estimate the recoverable amount of the asset as set out in Australian accounting standard AASB 136 *Impairment of Assets* (AASB 136). It is the responsibility of the auditor to make a critical assessment, with a questioning mind, of the validity of the evidence provided by the client.

107 Auditing Standard ASA 545 *Auditing Fair Value Measurements and Disclosures* (ASA 545) specifically requires the auditor to obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework. ASA 545 applies to fair value measurement for the purpose of impairment testing under the Australian accounting standards and similar impairment calculations, such as 'value in use' calculations.

108 In many engagement files there was insufficient evidence that the auditor had exercised professional scepticism when assessing the key assumptions used by the clients in measuring the fair value of assets and the judgement about whether impairment charges were necessary or adequate.

109 In the majority of those instances. there was insufficient evidence that the auditor challenged:

(a) the appropriateness of the growth rates used by the client. Often the growth rates appeared unrealistically high, but there was no evidence that this was questioned by the auditor or compared to the client's historical performance;

(b) the correctness of the discount rates applied by the client. Frequently, the auditor did not critically evaluate whether a discount rate used by a client reflected the risks specific to the relevant industry. This may

suggest that the auditor did not have had sufficient competence to properly evaluate the client's assumptions or calculations; and

(c) the accuracy of the source data used by the client in estimating future cash flows. Future cash flows are used when measuring the recoverable amount of an asset using the 'value in use' method and may be used in determining fair value less costs to sell. Often the engagement file did not contain evidence that the auditor had objectively evaluated whether the cash flows were complete, accurate and prepared in accordance with AASB 136 and consistent with other areas of the file (e.g. deferred tax assessments or going concern assessments).

110 In a smaller number of instances there was insufficient evidence that the auditor exercised professional scepticism in considering:

(a) whether the disclosures about fair value in the financial report were in accordance with the relevant Australian accounting standards in particular, if sensitivities were disclosed when a reasonable possible change in assumptions could lead to impairment. Where disclosure deficiencies were identified, it often appeared that the auditor was willing to agree with the client's disclosures rather than challenge them; and

(b) the number of cash generating units identified by the client and whether it was appropriate to apply the same discount rate to different cash generating units.

111 In some engagement files, the documentation on the file raised concerns about the competence of members of the audit engagement team to audit complex components of the client's fair value and impairment calculations. Where we have raised this concern, the firms have indicated that they will provide the relevant training and, where appropriate, ensure engagement teams consult with the internal technical specialists in the firm.

112 In some instances when the firm's internal technical specialists were consulted about fair value and impairment calculations, they raised matters of concern for the engagement team's consideration. However, the documentation on the engagement file did not always demonstrate that the engagement team conducted adequate additional procedures to address the matters raised by the technical specialists or sought the endorsement of technical specialists on the conclusions reached.

Going concern assessments

113 Auditing Standard ASA 570 *Going Concern* (ASA 570) requires an auditor to evaluate a client's assessment of an entity's ability to continue as a going concern. It also requires auditors to undertake specific procedures when events or conditions that may cast significant doubt on an entity's ability to continue as a going concern have been identified. During a global economic

downturn when there is reduced liquidity and reduced ability for companies to refinance debt or raise new funds, and/or pressure on results and asset values, an entity's ability to continue as a going concern can be at risk and accordingly this was a key audit area that we focused on.

114 In a small number of engagement files there was a lack of evidence that the auditor challenged evidence provided by the client to support their assumption that the entity was a going concern. It appears that the auditor often accepted the client's estimates of future cash flows without critically assessing the assumptions underlying those estimates

Analytical review procedures

115 In some of the engagement files the auditor did not undertake appropriate analytical procedures as required by Auditing Standard ASA 520 *Analytical Procedures* (ASA 520). In more than half of these cases, the analytical review procedures undertaken at the preliminary stage of the audit were not adequate to be considered a risk assessment procedure sufficient to obtain an understanding of the entity and its environment. In addition, in most of these cases, analytical review procedures were also not performed adequately at the final stage of the audit to gain an understanding of the whether the financial report as a whole was consistent with the auditor's understanding of the entity.

116 In almost half of these instances, the auditor relied on analytical review procedures as substantive tests for certain balances. However, in these cases the auditor did not sufficiently evidence:

(a) how the analytical review procedures provided appropriate audit evidence to support audit-specific assertions relating to those balances for example, the completeness, accuracy and existence of bank balances or debtors;

(b) that there was an appropriate relationship between the data used and the population being audited or that the source data was sufficiently independent;

(c) whether the expectation established was sufficiently precise to identify a material misstatement; and/or

(d) that the difference of the recorded balance from the expectation established was sufficiently investigated.

117 Often when analytical review procedures conducted by the auditor resulted in variances, the auditor accepted explanations provided by management of the client without corroborating or challenging those explanations or comparing them with the auditors' own understanding of client's operations.

Engagement quality control reviews

118 In many engagement files there was a lack of sufficient appropriate evidence of the engagement quality control reviews. This deficiency can raise questions about the effectiveness of the EQCR role, particularly given the:

(a) number of ASIC findings about engagement files that did not contain sufficient appropriate audit evidence to support the testing of and conclusions reached about key judgement or risk areas;

(b) lack of sufficient appropriate evidence that the EQCR actually reviewed the work done by the engagement team in key judgement or risk areas, with the file usually containing only a signature on an audit review checklist;

(c) many instances where time records indicated that the EQCR recorded spent less than 1% of the total time charged by the engagement team on an engagement; and

(d) small number of instances where the engagement quality control review was performed by a person who was not eligible to be an EQCR in accordance with the requirements of the Corporations Act. In addition, Auditing Standard ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements* (ASQC 1) sets out that an EQCR for an audit of the financial report of a listed entity is likely to be an individual with sufficient appropriate experience and the authority to act as an engagement partner on audits of financial reports of listed entities.

119 Auditing Standard ASA 220 *Quality Control for Audits of Historical Financial Information* (ASA 220) requires an engagement quality control review for audits of financial reports of listed entities that includes an objective evaluation of the significant judgements made by the engagement team and the conclusions reached in formulating the auditor's report.

120 To provide assurance that a high quality audit was undertaken, an engagement file needs to contain evidence that a qualified EQCR reviewed the file in accordance with the requirements of ASA 220.

121 We acknowledge that the Larger National and Other National and Network firms have implemented policies and procedures for the EQCR role and review. We also recognise that the time spent by EQCRs will vary from engagement to engagement and can be affected by the composition of the audit team, the size and risk profile of the client and the EQCR's familiarity with the client. However, given the extent of findings from our 2009–10 inspection and previous inspections, we continue to have concerns about the number of deficiencies observed in this area. Leaders of the firms should remind firm personnel about the importance of the role of the EQCR.

Other observations and findings

122 During our review of audit engagement files, other instances were noted where the auditor failed to perform certain audit procedures or did not undertake the procedures strictly in accordance with the relevant Australian auditing standard. A smaller number of audit engagement files did not contain sufficient appropriate evidence to demonstrate that the auditor undertook procedures to:

(a) ensure significant litigation or claims were identified. In some instances, solicitor's representation letters were not requested or obtained and there was no evidence on the engagement file of the alternative procedures the auditor performed to identify potential legal matters. In some instances where solicitor's letters were obtained, there was no evidence that the auditor considered whether matters in these letters needed to be accounted for and disclosed;

(b) select an appropriate sample of items for audit testing. In those circumstances, the auditor did not document sufficiently the rationale for the size or the method used for selecting the sample;

(c) test journal entries and other adjustments throughout the financial year. In our view, given that journal entries and other adjustments can be used to manipulate financial results, testing of unusual and material journal entries is an important audit procedure that should be performed to cover the whole financial year; and

(d) establish an appropriate quantitative materiality level to plan risk assessment procedures and other procedures. In those circumstances, the auditor did not meet the requirements of the firm's policy or the Australian auditing standards by either setting the materiality at an inappropriate level or using an inappropriate basis for setting materiality.

123 In most of these cases, the auditor provided oral explanations about the auditor's consideration of these specific matters, but this was not documented on the engagement file. If the evidence of the work done is not documented it is difficult to ascertain the nature, timing and extent of audit procedures the auditor performed to reach a conclusion and comply with the requirements of the Australian auditing standards.

Smaller firms

124 During 2009–10 we conducted inspections of eight Smaller firms not previously inspected. Taking into consideration the size and nature of these Smaller firms and the profile of the clients they audit, we focused on the review of nine listed entity audit engagement files selected based on risk criteria to assess audit quality.

125 Our review of the engagement files concentrated on the substance of the auditors' work, to assess if there was sufficient appropriate audit evidence on the file to support the key audit considerations and the conclusions of the auditor. Our reviews were not designed to detect all instances of non-compliance or to confirm all aspects of the audit opinion. During 2009–10, we reported separately to each of the firms on the findings from our reviews.

Common observations and findings

126 Our review of audit engagement files of Smaller firms raised concerns about the quality of audit evidence on five of the nine engagement files and the extent and timing of engagement quality control reviews.

Audit evidence and documentation

127 In our last public report we noted that in a large number of engagement files there was insufficient evidence to support key audit assertions. We noted the area of evidence and documentation as a major area of focus for Smaller firms.

128 In 2009–10 we continued to find instances where the engagement files failed to provide sufficient appropriate audit evidence to support the nature, timing and extent of audit procedures performed and the conclusions reached on key judgement and risk areas. In particular, we noted instances where some areas of the audit were performed utilising checklists with no supporting evidence or documentation of the procedures undertaken.

129 In a small number of the engagement files it was difficult to see how the auditor objectively assessed the evidence presented by clients and exercised an appropriate attitude of professional scepticism. In areas that require client management to make estimates of or judgements about significant and material areas of a financial report, a questioning mind and objective approach to assessing evidence is critical.

Consideration of the risk of fraud

130 We found in a number of the engagement files reviewed that there was insufficient audit evidence to demonstrate that the auditor had complied with ASA 240 and made enquiries of management about their:

(a) assessment of the risk of fraud;

(b) processes for identifying and responding to fraud risks;

(c) communication with those charged with governance about their processes;

(d) communications to employees about management's views on business practices and ethical behaviour; and

(e) knowledge of any actual, suspected or alleged fraud.

131 In addition, there was no evidence that the auditor obtained an understanding of how those charged with the governance of the entity exercised oversight of management's processes for identifying and responding to the risk of fraud.

132 Smaller firms need to be diligent in their consideration of the risk of fraud so that they are able to design and perform adequate audit procedures to cover the risk of fraud.

Financial statement disclosures

133 In a number of cases we found deficiencies in the financial statements of the entities audited. It was not evident from the documentation on the file whether the auditor had complied with the requirements of ASA 330 to evaluate whether the overall presentation of the financial report, including the financial disclosures, was in accordance with the entity's applicable reporting financial reporting framework.

134 In addition, in one engagement file there was insufficient evidence that the auditor had reviewed other information in the entity's annual report to ensure it was consistent with audited financial information.

Related parties

135 In a number of engagement files there was no evidence of audit procedures performed to address the risk of the financial reports containing material misstatements that result from the existence of related parties and related party transactions. Smaller firms need to ensure they fully address the requirements for the audit of related party transactions, particularly given the nature of related party transactions and possible complexities associated with the transactions and their audit.

Laws and regulations

136 In some engagement files there was a lack of sufficient appropriate evidence that the auditor assessed the client's compliance with laws and regulations as required by Auditing Standard ASA 250 *Consideration of Laws and Regulations in an Audit of a Financial Report* (ASA 250).

Engagement quality control reviews

137 We found little or no evidence on the majority of the engagement files to support the engagement quality control review. This review should include an objective evaluation of the significant judgements made by the engagement team and the conclusions reached in formulating the auditor's report. Engagement quality control reviews provide an essential overlay of quality control, particularly for Smaller firms that have yet to develop and implement an internal monitoring program: see paragraph 185. In these instances, it may be warranted for Smaller firms to take a more rigorous

approach to engagement quality control reviews and go beyond the requirements of the Australian auditing standards in order to ensure a high quality audit is achieved.

D Detailed observations and findings: Quality control

Key points

Some Larger National firms should improve their independence systems and testing of those systems to avoid contraventions of the independence requirements of the Corporations Act.

Other National and Network firms can improve some aspects of their quality control systems, particularly by emphasising the importance of audit quality and independence in messages from leaders of the firm, and including audit quality and independence as clear criteria in partner performance evaluations.

Smaller firms need to continue to develop and implement many aspects of their quality control systems; in particular, systems to enable compliance with the independence requirements of the Corporations Act and ethical and professional requirements, and procedures to systematically and rigorously examine and monitor audit quality.

Larger National and Other National and Network firms

138 ASQC 1 was effective from 1 January 2010. ASQC 1 is based on the equivalent international standard on quality control that was issued by the International Ethics Standards Board for Accountants and is equivalent to Accounting Professional and Ethical Standard APES 320 *Quality Control for Firms* (APES 320).

139 The firm's quality control systems enable them to meet the requirements of ASQC 1 and ASA 220. Our assessment, therefore, is based on the elements set out in ASQC 1 and APES 320:

(a) leadership responsibilities for quality within the firm;

(b) ethical requirements;

(c) acceptance and continuance of client relationships and specific engagements;

(d) human resources, engagement performance; and

(e) monitoring.

140 Where, in a previous inspection, we did not have any observations or findings for a particular element of a quality control system, we only reviewed and tested key changes to these elements. Our observations and findings arising from our review of the elements reviewed and tested during 2009–10 are set out in the sections below.

141 Because the extent and composition of the quality control systems can vary between the Larger National firms and the Other National and Network firms due to their structure and the resources available within the networks, the results for the Larger National firms and the Other National and Network firms are shown separately.

Larger National firms

Leadership responsibilities for quality within the firm

142 Larger National firms have policies and procedures that recognise that quality is essential to performing audits in accordance with legal and professional requirements.

143 The leadership of these firms remain committed to an appropriate 'tone at the top' and we consider this commitment continues to have a positive and ongoing impact on maintaining a strong culture of audit quality and independence.

144 However, based on the observations and findings from some Larger National firms' own monitoring processes and ASIC's observations and findings in this report, leaders of these firms should continue to reinforce the need to:

(a) conduct high quality audits that can withstand internal and external scrutiny, and demonstrate this through obtaining appropriate audit evidence that is sufficiently documented on the engagement file and rigorous engagement quality control reviews;

(b) exercise a heightened level of professional scepticism in significant judgemental areas of the audit; and

(c) comply with independence requirements of the Corporations Act and the firms' own independence policies.

Ethical requirements and independence

Auditor rotation requirement contraventions

145 During 2009–10, two contraventions of the auditor rotation requirements of the Corporations Act were noted at a Larger National firm. Once these contraventions were identified by the Larger National firm's internal monitoring systems they were rectified by the firm and the matters were disclosed to ASIC.

146 The contraventions involved a partner playing a significant role either as an engagement partner or an EQCR in the audit of a listed client for more than five out of seven successive financial years. Consequently, a new partner and a new EQCR were assigned to the listed client.

Contravention of other independence requirements

147 A Larger National firm identified and reported to us a contravention of the independence requirements of the Corporations Act. The contravention involved a partner holding a direct financial interest in a listed audit client.

148 Although the partner did not provide any audit or non-audit services to the audit client, Accounting Professional and Ethical Standard APES 110 *Code of Ethics for Professional Accountants* (APES 110) notes that if any partner of a firm, in the office in which the engagement partner practices in connection with the audit, holds a direct financial interest in an audit client, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level. The partner no longer holds the position of partner at this Larger National firm.

Policies, systems and processes

149 The Larger National firms have independence policies and systems that reflect the requirements of the Corporations Act, and also require partners and senior staff to disclose their investments on interactive databases that are automatically matched with the firms' prohibited securities lists. During 2009–10, the Larger National firms continued to test how partners complied with these policies and systems.

150 Although the firms continue to identify instances of non-compliance with their own policies that include requirements that go further than the Corporations Act, the number of instances of non-compliance has not increased compared to prior years.

151 Our review of the Larger National firms' policies, systems and processes for ethical and independence requirements found a small number of instances where there was scope for enhancement. These findings were brought to the attention of the relevant firms in our private reports to them.

Engagement performance

152 All Larger National firms continue to enhance their systems and processes to better integrate audit technology with their audit methodologies, and adopt changes to policies and processes with the introduction of the Clarity auditing standards. Some firms implemented, or are in the process of implementing, new audit technology systems.

153 The leadership of some firms need to reinforce messages to partners and staff about the importance of following the firm's policies and the relevant Australian auditing standards when performing specific audit procedures. These relate to the nature, extent and timing of audit procedures to be performed for specific account balances in the financial report, ensuring that reasonable assurance is obtained over specific audit assertions.

154 Where there is divergence from firm policies, adequate explanations should be provided in the engagement files. These explanations should contain details of the alternative audit procedures performed to obtain the necessary assurance over specific account balances.

155 A number of firms have strategies in place to ensure audit engagements are conducted in the most efficient and effective manner. However, the firms need to focus on these aspects in the performance of audit engagements, in their audit training, partner and staff briefings, and in scoping their internal quality control review activities to ensure that audit quality is not compromised.

Monitoring

156 All of the Larger National firms have comprehensive policies and procedures for monitoring their audit quality in accordance with legal and professional requirements. The Larger National firms regularly undertake rigorous inspections of a selection of completed audit engagements. They use the results of these inspections to enhance their audit quality systems, if necessary, and direct the focus of staff training.

157 Two of the Larger National firms need to improve their processes for reporting to ASIC about contraventions and suspected contraventions of the Corporations Act, in accordance with s311. These include contraventions of the independence requirements of the Corporations Act.

Human resources

158 All of the Larger National firms have mature systems and processes in place to provide assurance that personnel are competent, capable and committed to ethical principles. We found a small number of instances where there is scope for the Larger National firms to improve aspects of these systems.

159 To provide clear messages to personnel about the importance of complying with ethical principles:

(a) one Larger National firm should consider the sufficiency of internal disciplinary action for contraventions of the rotation requirements of the Corporations Act, to ensure they are commensurate with the nature of the breaches identified; and

(b) another Larger National firm should formally publish its disciplinary policy for staff below the level of partner, and communicate the key messages of the policy to the relevant personnel.

160 To ensure that the sufficiency and appropriateness of training for personnel can be monitored, one Larger National firm needs to ensure it continues to properly record attendance by personnel at training courses.

Other National and Network firms

Leadership responsibilities for quality within the firm

161 All of the Other National and Network firms recognise the importance of audit quality. However, some of these firms need to strengthen the 'tone at the top' messages to partners and staff about audit quality and the consequences of non-compliance. This is essential at the Other National and Network firms that we inspected for the first time during 2009–10.

162 The messages from the leadership at two of the Other National and Network firms should emphasise the overriding importance of audit quality and commitment to independence and ethical principles. 'Tone at the top' messages can be communicated in variety of ways, including through formal and informal dialogue, at training seminars and conferences and by incorporating them into mission statements or strategic plans.

163 Some of the Other National and Network firms can improve the communication of their messages about audit quality and ethics and independence by making them transparent in strategic plans or an integral part of agendas for board and executive meetings.

Ethical requirements and independence issues

Auditor rotation

164 During 2009–10, we noted one instance where an audit partner had played a significant role in the audit of a listed client for in excess of five years, in contravention of the Corporations Act. The audit of the listed client has been assigned to another partner.

165 While most of the Other National and Network firms have systems in place to monitor compliance with the auditor rotation requirement of the Corporations Act, one Other National and Network firm needs to implement processes to ensure it can satisfy these legislative requirements. Another Other National and Network firm needs to improve partner rotation plans to ensure that its member firms are able to manage the rotation of partners for existing audit clients that become listed.

Policies and procedures

166 All of the Other National and Network firms inspected have policies and processes in place to facilitate compliance with the independence requirements of the Corporations Act and professional standards. However, the completeness and adequacy of the independence policies and processes varied, reflecting the nature or maturity of the national partnership or network structure of those firms.

167 The independence policies and processes of more than half of the Other National and Network firms need improvement to ensure that they are consistent with the requirements of the Corporations Act and Australian accounting professional and ethical standards, and are applied consistently across the member firms of the network.

Testing of independence systems

168 Approximately two thirds of the Other National and Network firms are not testing their independence systems and processes to ensure compliance with their legal and professional independence requirements. A quarter of the Other National and Network firms have commenced testing their independence systems and processes. However, in one instance the testing does not extend to assessing the completeness and accuracy of the partners' annual independence declarations and, in another instance, not all of the member firms are testing their independence systems across the network.

169 Without a rigorous testing program, firms can only place limited reliance on the effectiveness of their independence systems and processes. An effective testing program can identify potential non-compliance on an ongoing basis. Firms that have robust testing programs in place are identifying non-compliance with their policies and the Corporations Act.

170 Where firms are testing their independence systems and processes, the communication of the results of the testing process to all personnel sends a strong and clear message about the importance of independence.

Acceptance and continuance of client relationships and specific engagements

171 The majority of the Other National and Network firms have adequate policies and procedures in place for the acceptance and continuance of client relationships and specific engagements. We noted a small number of instances where the policies and procedures could be improved.

172 One of the Other National and Network firms needs to implement a formal procedure to document the process for performing conflict checks prior to accepting a new audit client. Two of the Other National and Network firms can improve their client acceptance and continuance evaluation procedures by, in one instance, including criteria for accepting clients in specific industries and, in another, by requiring a concurring partner approve acceptance and continuance decisions.

173 The primary focus of client acceptance and continuance procedures should continue to be on independence considerations, possible conflicts of interest and whether the firm continues to have the requisite skills to conduct an engagement (as required by ASQC 1).

Engagement performance

174 Most of the Other National and Network firms need to enhance their audit manuals so that they include complete policies and procedures for all elements of undertaking an audit, and also provide practical guidance about the application of the Australian auditing standards and the firm's audit tool.

175 We noted that in some instances the audit manuals did not contain formal policies on sampling, archiving and safe custody (integrity) of engagement files. The audit manuals were also deficient in guiding audit engagement teams about the role of the EQCR, the extent and timing of an engagement quality control review, and the procedures necessary to enable an auditor to rely on the work of other auditors or experts.

176 We also found in some of the Other National and Network firms that there was inconsistent application by member firms of the network of parts of the audit manuals, including the approach to sampling and the form and content of audit reports issued.

177 To achieve a high quality audit, it is critical for the firms to have comprehensive audit manuals that accurately reflect the requirements of the Australian auditing standards and the Corporations Act and that are consistently followed by all the member firms in the network.

Monitoring

178 All of the Other National and Network firms have procedures in place to facilitate monitoring of audit quality in accordance with the requirements of ASQC 1. At the time of our inspection, one of the Other National and Network firms had not completed its first monitoring program. One of the Other National and Network firms can improve its monitoring processes by establishing a mandatory action plan for audit deficiencies identified from the monitoring process, including training and following up the proposed remedial action.

179 Many of the Other National and Network firms need to adopt formal policies and procedures to deal appropriately with complaints and allegations of non-compliance with professional standards and regulatory and legal requirements.

Human resources

180 The majority of the Other National and Network firms need to implement policies and procedures to ensure adequate consideration is given to audit quality and independence in partner performance evaluations. A clear understanding of audit quality and adherence to ethical principles should be key criteria for advancement and remuneration decisions.

181 Some of the Other National and Network firms do not document partner evaluations. One of the Other National and Network firms does not have a formal evaluation process for partners. A formal documented evaluation process is important to ensure that partners and staff are aware of the firm's expectations for audit quality and ethical principles. The evaluation process should also enable partners and staff to receive meaningful feedback on their performance, including advice on areas of improvement and additional training needs.

182 The results of internal and external quality monitoring processes and outcomes of the firms' independence testing should be incorporated into individual performance evaluation and remuneration decisions at most Other National and Network firms.

Smaller firms

183 ASIC conducted limited-scope inspections on eight Smaller firms during the audit inspection program in 2009–10. The audit inspection program for Smaller firms is targeted in scope, taking into consideration the size, client profile and nature of these firms. In conducting the inspections of the quality control systems of Smaller firms we focused on core aspects of the systems as they related to audit quality on the nine engagement files we reviewed at the eight Smaller firms.

Quality control systems

184 While it is recognised that the size and characteristics of Smaller firms may limit the sophistication of their quality control systems, Smaller firms undertaking audits are still required to comply with their legal and professional obligations. On this basis, we found a number of areas where Smaller firms need to take action to ensure they can comply with the requirements of the Corporations Act and professional standards.

185 The majority of Smaller firms do not have a monitoring program in place that includes a periodic inspection of a selection of completed engagement files. Without ongoing evaluation and monitoring of their quality control systems, Smaller firms may not be able ascertain whether their systems are operating effectively to facilitate compliance with professional standards and other relevant legal and regulatory requirements. While some Smaller firms rely on the outcomes of The Institute of Chartered Accountants Australia (ICAA) quality reviews and ASIC inspections, these are not a substitute for an internal monitoring program within the firm.

186 Some Smaller firms are yet to formalise policies and procedures for the acceptance and continuance of client relationships and specific engagements.

Smaller firms need to ensure they develop, implement and are able to comply with such policies, so that they undertake or continue to undertake only those engagements for which they have the competence, capabilities and resources and, most importantly, from which they are free of conflicts.

187 One of the Smaller firms had not yet developed formal policies and procedures for the completion of annual independence declarations by personnel of the firm as required by ASQC 1. The collection and monitoring of such information is crucial to identify any potential conflicts of interests that could result in a contravention of the Corporations Act if the firm accepted a new engagement or continued with existing engagements.

188 We also suggested a number of improvements to some of the Smaller firms in relation to the resources being utilised, such as ensuring audit manuals or audit guidance are up-to-date, and provide adequate guidance to staff. The introduction of the Clarity auditing standards is the opportune time for Smaller firms to review their audit manuals and tools to ensure that they accurately reflect the requirements of the Australian auditing standards and the Corporations Act.

E Future focuses

Key points

Our future focuses will include:

- conducting inspections of those firms that audit significant public interest entities, focusing on entities and industries with perceived heightened risks based on current market conditions;
- refining our inspection approach to ensure that it continues to be effective and consistent with international best practices;
- following up the extent to which matters noted in our previous inspections have been addressed, with an emphasis on performing engagement file reviews, particularly of significant audit judgement areas, to assess audit quality;
- monitoring the impact of regulatory developments in auditing;
- ongoing engagement with firms on the future inspection reporting process and audit quality initiatives; and
- continued collaboration with foreign regulators to minimise the regulatory burden on Australian auditing professionals.

Inspection scope and process

189 The focus of our audit inspection program will continue to be those firms that audit entities likely to be of greater public interest, and those entities and industries that are more vulnerable to the risks emanating from existing and emerging market conditions.

190 We will continue to conduct follow-up inspections of firms. Where significant issues were identified in previous inspections, we will escalate follow-up inspections to ensure the firms are taking prompt and appropriate action to address our observations and findings. Our inspections of Smaller firms will continue to extend to those firms that have not previously been subject to an audit inspection.

191 Our future reviews of engagement files will include financial institutions, managed investments schemes and audits of Australian financial services (AFS) licensees.

192 We will continue to monitor and examine the causes of recent corporate collapses. Where deficiencies in auditor conduct appear to have contributed to a lack of transparency in the financial position and financial performance of an entity on a timely basis leading up to the collapse, we will focus on these areas in our future audit inspections.

193 Our inspection process is continually reviewed to ensure that it remains effective. We are considering further refinements to the nature and extent of our engagement file selection processes, file reviews and other inspection processes, such as including a focus on reviewing the firm's internal specialist technical groups (e.g. technical accounting, treasury, actuarial, taxation) that support audit engagement teams to assess processes applied by those groups on matters referred and the quality of their advice.

Specific areas of focus

Audit quality and evidence

194 Given the issues noted in this inspection report, our future inspections will continue to focus on whether the auditors obtained sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base their opinion.

195 Where appropriate, we will challenge engagement partners on whether the evidence obtained and documented on engagement files for specific audit assertions is sufficient and appropriate and supports the significant judgements made to reach their conclusions and form their opinions.

196 If there is no documentation on an engagement file, we will presume that the auditor did not obtain the necessary audit evidence to support the procedures performed or conclusions reached.

Professional scepticism

197 The level of professional scepticism exercised by auditors has been in the spotlight during the global economic downturn and the resultant high profile corporate collapses worldwide.

198 In areas and circumstances that involve significant judgements by clients when preparing their financial statements, auditors should have a heightened level of professional scepticism. A lack of documented evidence of the exercise of professional scepticism by engagement partners and teams could lead to potential concerns relating to the objectivity and quality of audit work undertaken.

199 Based on the above and the findings in some of the 2009–10 inspections, professional scepticism exercised by auditors will be an area of continued focus in future inspections. We will review engagement files for evidence of the extent of professional scepticism exercised by engagement teams in significant judgement areas.

Relying on the work of others

200 In this report we have noted instances where we had concerns about the auditor relying on the work of experts (internal and external) and other auditors (in the same network as the principal auditor or in an unrelated network). In light of these concerns and changes resulting from the Clarity auditing standards—for example, the changes to ASA 600, noted in paragraph 82—we will continue to focus on areas where the auditor relies on the work performed by others to draw conclusions on which to base the audit opinion.

201 We will review engagement files for evidence that the auditor assessed the competence and objectivity of experts and other auditors, considered whether the scope of the work performed by others was adequate for the purposes of the audit, and evaluated the appropriateness of the work performed by others as audit evidence for the audit assertions being considered. In particular, we will consider whether the auditor has sufficient skills to review the work performed by an expert used by the audit client or should have engaged their own independent expert, and whether sufficient audit work has been performed on information used by experts. Our selection of audit engagement files will include entities where:

(a) there were group audit arrangements;

(b) the entity used service organisations;

(c) joint venture operations were included in an entity's financial report; or

(d) experts were used by the entity.

Audit fees and audit efficiencies

202 While it is not ASIC's role to interfere in the setting of audit fees between a firm and its client, large reductions in audit fees have the potential impact on audit quality.

203 To understand the level of fee reductions, in 2010 we wrote to the 14 largest firms requesting a listing of all successful formal proposals for audits of financial reports of new or existing clients. We used this information to select and review a sample of entities with substantial fee reductions as part of some inspections. While our findings to date are not indicative of any negative impact on audit quality, we are aware that in most instances the impact on audit quality would only be evident in subsequent years.

204 We will continue to target engagement files where there is evidence of large fee reduction on new or existing audits without any apparent underlying changes to business operations. Our review of engagement files will focus on the sufficiency of the audit quality, and we will continue to focus on firms' acceptance and continuance processes in this regard.

205 In addition, we are aware that a number of firms have strategies in place to ensure audit engagements are conducted in the most efficient manner. We will focus on these initiatives to ensure that audit quality is not compromised as a result of their implementation.

Other areas of focus

206 Other specific areas that we intend to focus on in future inspections include:

(a) any areas of deficiency in auditor conduct that may have contributed to a lack of transparency in the financial position and financial performance of an entity on a timely basis leading up to a corporate collapse; ;

(b) the auditors' understanding of the business model of the entity and risk assessment for individual engagements, and the auditors' interaction with the audit committee to ensure that key areas of risk are included in the audit strategy;

(c) application of the new 'Clarity' auditing standards, including standards that have undergone considerable change;

(d) monitoring 'opinion shopping', particularly where there are communications with an audit firm about their views on specific accounting treatments prior to acceptance of a new engagement;

(e) the involvement of the engagement partners and EQCRs at different stages of the audit, including planning, consultations with the engagement team and reviewing key judgements and conclusions reached;

(f) the quality and extent of the auditor's communications with those charged with governance of the entity, particularly communication of unadjusted differences and the significant audit judgement areas of going concern assessments, fair value measurement and impairment testing;

(g) the extent of audit procedures performed and internal consultations;

(h) the audit of financial statement disclosures, to ensure that the investing public is properly informed;

(i) compliance with financial reporting disclosure requirements through our financial reporting surveillances and targeting those entities with deficient disclosures for audit inspections;

(j) the adequacy and timeliness of auditors reporting suspected contraventions of the Corporations Act under s311, s601HG and s990K; and

(k) scrutinising compliance with the auditor rotation requirements of the Corporations Act, including EQCRs as they are required to be registered company auditors.

Regulatory developments

207 In the wake of the global financial crisis, questions are being asked about whether the role of auditors can be enhanced to mitigate any new financial risk in the future. A number of matters are being considered globally and locally by governments and regulators as a result of the global economic downturn, such as Treasury's consultation paper on audit quality in Australia.[5] We will actively monitor future regulatory developments in auditing and consider their impact on the audit inspection program.

208 Specific areas of regulatory developments that we will focus on in the next cycle of audit inspections are detailed below.

Clarity auditing standards

209 Auditing standards have been revised and redrafted in the 'Clarity' format internationally. The Auditing and Assurance Standards Board (AUASB) issued revised and redrafted Australian auditing standards in the Clarity format in October 2009 and they are operative for financial reporting periods commencing on or after 1 January 2010.

210 During our more recent inspections, we have engaged in discussions with the firms' executive leaders and assessed the firms' readiness for the Clarity auditing standards. The firms were at various stages of effecting changes to policies, systems and processes and training staff, but the majority had plans in place and were progressing with their implementation strategies.

211 Firms need to invest time and resources into understanding the changed requirements of these new standards, particularly standards (such as ASA 600) that have substantial additional requirements, and ensure their audit methodology meets the new or amended requirements.

212 We will shortly commence reviews of audit engagement files under the Clarity auditing standards. To ensure that the profession is well informed on a timely basis, we intend to issue a media release on our initial overall findings from these reviews in early 2012.

New code of ethics: Revised APES 110

213 The APESB has released a revised APES 110, the Code of Ethics for Professional Accountants, which aligns Australia's professional requirements with international standards and introduces Australian specific requirements relating to inadvertent violations and multiple threats to auditor's independence.

[5] Consultation Paper, *Audit Quality in Australia: A Strategic Review*, Treasury, 1 March 2010.

214 Effective from 1 July 2011, the revised APES 110 extends the current rotation provisions to all key audit partners and the independence requirements for audits of listed entities to all public interest entities. Among other changes made, the revised APES 110 further strengthens some of the requirements relating to the provision of non-assurance services to audit clients.

215 Firms will need to be aware of all the relevant changes, particularly provisions relating to the new concepts of public interest entities and key audit partners, which for transitional purposes will not take effect until 1 January 2012.

216 Firms will also need to be cautious in the interpretation and application of the requirements in the revised APES 110 that differ and, in some instances, are less stringent than those imposed by the Corporations Act.

International collaboration

217 ASIC continues to work to minimise the regulatory burden on Australian auditing professionals by seeking arrangements with other international audit oversight bodies. These arrangements involve reliance on ASIC by other regulators or conducting work either jointly with them or on their behalf.

218 The PCAOB has a responsibility to monitor compliance of Australian auditors with the Sarbanes-Oxley Act (US). In 2007, ASIC entered into an arrangement with the PCAOB to conduct joint audit inspections and has been doing so since this time.

219 In January 2011, the European Commission recognised the equivalence of the audit oversight system in Australia. EU audit regulators can now enter into cooperative arrangements with ASIC, in order to rely on ASIC's audit firm inspections carried out on Australian firms that audit Australian companies listed in the European Union, or Australian subsidiaries of EU companies.

220 We will continue to work with other international audit regulation counterparts to reduce any regulatory overlap. Where possible, we will concentrate on maximising cross-border recognition opportunities and establishing regulatory cooperation arrangements.

221 ASIC is an active member of the International Forum of Independent Audit Regulators (IFIAR), comprising audit oversight bodies from around the globe. IFIAR's goals include sharing knowledge of the audit market between regulators, promoting collaboration and consistency in regulatory activity, and providing a platform for dialogue with other organisations that have an interest in audit quality. ASIC chairs the International Co-operation Working

Group and is a member of the Global Public Policy Committee Working Group.

222 ASIC is also a member of the International Organization of Securities Commissions (IOSCO) and actively participates in IOSCO Standing Committee No.1 on Accounting, Auditing and Disclosure. We are members of the Auditing Subcommittee and the Accounting Subcommittee, as well as chairing the International Financial Reporting Standards Regulatory Interpretation and Enforcement Subcommittee.

223 Our contribution and participation at the IFIAR and IOSCO will continue to ensure that our inspection techniques and processes remain current and relevant in the changing global financial economy.

224 We will continue to actively monitor future developments in auditing and will respond to trends and issues through our inspection process and other targeted project work.

Appendix: How we conducted our work

225 This report covers inspections of firms substantially completed between 1 July 2009 and 31 December 2010. The nature of our monitoring approach means that inspections were spread throughout the period, with inspections starting and concluding at some firms earlier than at others.

Our monitoring approach

Larger National and Other National and Network firms

226 We focused on assessing whether each firm had documented and implemented a quality control system that provides reasonable assurance that:

(a) the firms comply with the auditor independence requirements in Div 3, 4 and 5 of Pt 2M.4 of the Corporations Act (i.e. independence); and

(b) the firms' audit methodologies facilitate the conduct of their audits in accordance with the Australian auditing standards as required in Div 3 of Pt 2M.3 of the Corporations Act (i.e. audit quality).

227 It is not the purpose of our inspection program to benchmark the firms or to make specific recommendations on how to improve independence or audit quality policies and systems. However, during our inspection we highlighted to each firm suggested areas for improvement.

228 In particular, we considered the following areas of each of the firm's quality control systems:

(a) leadership responsibilities for quality within the firm;

(b) ethical requirements;

(c) acceptance and continuance of client relationships and specific engagements;

(d) human resources;

(e) engagement performance; and

(f) monitoring.

229 Our inspections concentrated first on reviewing each firm's independence systems and processes, including examining each firm's testing results. We conducted only limited testing of each firm's systems.

230 Second, we examined each firm's audit methodology for compliance with Australian auditing standards operative for financial reporting periods commencing prior to the date of our inspection.

231 Third, we reviewed the conduct of aspects of a limited number of archived individual audit engagements for compliance with each firm's stated audit methodology and applicable Australian auditing standards as at the date of each audit or review. We also focused on specific areas most affected by the global economic downturn. Each review concentrated on the substance of work and on whether sufficient appropriate audit evidence was on file to support the conclusions reached for key decisions and significant judgements about the audit.

232 Our work programs are tailored to focus on key risk areas for each audit. They are not designed to find minor instances of non-compliance. We challenged audit partners regarding the basis on which significant judgements were made.

Smaller firms

233 To reflect the size and client profile of Smaller firms, our inspection approach is limited compared with inspections of Larger National firms and Other National and Network firms.

234 A limited inspection of a Smaller firm comprised:

(a) conducting a review of aspects of generally one archived audit engagement file of a listed entity for compliance with each firm's stated audit methodology and the applicable Australian auditing standards as at the date of each audit or review; and

(b) holding discussions with leaders, engagement partners and other senior members of the engagement team (for the file selected) about the engagement file reviewed and certain policies and procedures relating to auditor independence and audit quality employed by the firm.

235 The inspection process is not designed to gain a comprehensive understanding of the firms' quality control systems; instead, it focuses on the quality of audit conduct. Enquiries were in the context of observations specific to the engagement reviewed and therefore may vary across firms where different risks are identified.

236 Smaller firm engagement file reviews were mainly conducted at our offices, with on-site activities limited to discussions with firm personnel at the commencement and the completion of the inspection.

The inspection process

237 The inspection process was designed to gain an understanding of:

(a) the quality of audit work by the firm;

(b) the firms' executive leadership direction and strategic priorities for independence and audit quality;

(c) the firms' policies and systems for ensuring audit quality and compliance with their independence obligations;

(d) the firms' independence and audit methodology training programs;

(e) the links between the firms' independence and audit quality policies and the performance management processes; and

(f) internal monitoring programs conducted by the firms.

238 In conducting our inspections, we:

(a) reviewed material provided by the firms under notice pursuant to the ASIC Act;

(b) reviewed aspects of a selection of archived audit engagements at each firm, weighted towards listed entities;

(c) reviewed the firms' systems and processes for managing compliance with the audit independence requirements of the Corporations Act and for ensuring audit quality;

(d) conducted limited testing of the firms' compliance with its independence and audit quality policies, systems and processes

(e) interviewed selected partners holding leadership roles in the firms;

(f) interviewed selected human resources representatives;

(g) interviewed a number of the firms' other partners and staff; and

(h) in the case of Larger National, and Other National and Network firms, visited some of their capital city offices and interviewed selected partners and staff.

Key terms

Term	Meaning in this document
AASB 101 (for example)	An Australian accounting standard (in this example numbered 101)
AFS licensee	A person who holds an Australian financial services licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
APES 110 (for example)	An Australian accounting professional and ethical standard (in this example numbered 110)
APESB	Accounting Professional and Ethical Standards Board
ASA 200 (for example)	An Australian auditing standard (in this example numbered 200)
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001* (Cth)
ASQC 1	An Australian auditing standard on quality control
ASX	The exchange market known as ASX, operated by ASX Limited
AUASB	Auditing and Assurance Standards Board
Australian accounting professional and ethical standards	Standards issued by the APESB
Australian accounting standards	Standards issued by the Australian Accounting Standards Board pursuant to s334 of the Corporations Act
Australian auditing standards	Standards issued by the AUASB pursuant to s336 of the Corporations Act
Clarity auditing standards	Australian auditing standards revised and redrafted to conform with the 'Clarity' International Standards on Auditing issued by the International Auditing and Assurance Standards Board
Clarity format	The format of auditing standards resulting from the International Auditing and Assurance Standards Board 'Clarity' project to enhance the understanding and implementation of auditing standards, as well as to facilitate translation.
CLERP 9 Act	*Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth)

Term	Meaning in this document
Corporations Act	*Corporations Act 2001* (Cth), including regulations made for the purposes of that Act
engagement quality control review	A process designed to provide an objective evaluation, before the auditor's report is issued, of the significant judgements the engagement team made and the conclusions they reached in formulating the auditor's report
EQCR	Engagement quality control reviewer
firm	An audit firm inspected by ASIC as part of the audit inspection program
FRC	Financial Reporting Council
ICAA	The Institute of Chartered Accountants Australia
IFIAR	International Forum of Independent Audit Regulators
IOSCO	International Organization of Securities Commissions
Larger National firms	Firms that audit numerous listed entities (more that 5% by market capitalisation) and are national partnerships and members of a global network with multiple offices
Other National and Network firms	Firms with national partnerships or individual offices that audit many listed entities and are members of a national or international network
PCAOB	Public Company Accounting Oversight Board (US)
s311 (for example)	A section of the Corporations Act (in this example numbered 311), unless otherwise specified
Sarbanes-Oxley (US)	*Sarbanes-Oxley Act 2002* (US)
Smaller firms	Firms with small number of audit partners that audit a limited number of listed entities

Related information

Legislation

ASIC Act

CLERP 9 Act

Corporations Act, Pt 2M.3, Div 3, s311, Pt 2M.4, Div 3, 4, 5

Sarbanes-Oxley Act (US)

Standards

AASB 101 *Presentation of Financial Statements*

AASB 136 *Impairment of Assets*

APES 110 *Code of Ethics for Professional Accountants*

APES 320 *Quality Control for Firms*

ASA 200 *Objective and General Principles Governing an Audit of a Financial Report*

ASA 220 *Quality Control for Audits of Historical Financial Information*

ASA 230 *Audit Documentation*

ASA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report*

ASA 250 *Consideration of Laws and Regulations in an Audit of a Financial Report*

ASA 330 *The Auditor's Procedures in Response to Assessed Risks*

ASA 500 *Audit Evidence*

ASA 520 *Analytical Procedures*

ASA 545 *Auditing Fair Value Measurements and Disclosures*

ASA 570 *Going Concern*

ASA 600 *Using the Work of Another Auditor*

ASA 620 *Using the Work of an Expert*

ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements*

APPENDIX 4

Australian Securities and Investments Commission, Report 192: Audit inspection program public report for 2008-09 (March 2010)

The text of the Australian Securities and Investments Commission, *Report 192: Audit inspection program public report for 2008-09* (March 2010) is attached as Appendix 4.

ASIC
Australian Securities & Investments Commission

REPORT 192

Audit inspection program public report for 2008–09

March 2010

About this report

This report sets out key themes and issues identified by ASIC's audit inspection program for 2008–09.

We expect this report to be beneficial to the audit firms we inspected, other audit firms, the investing public, companies, audit committees and other interested stakeholders.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Scope/Disclaimer

Sections of this report may describe deficiencies or potential deficiencies in the systems, policies, procedures, practices or conduct of some of the 19 audit firms inspected (Firms). The absence of a reference in this report to any other aspect of a Firm's systems, policies, procedures, practices or conduct should not be construed as approval by ASIC of those aspects, or any indication that in ASIC's view those aspects comply with relevant laws and professional standards.

In the course of reviewing aspects of a limited sample of selected audit and review engagements, an inspection may identify ways in which a particular audit or review is deficient. It is not the purpose of an inspection, however, to review all of the Firm's audit or review engagements or to identify every aspect in which a reviewed audit or review may be deficient. Accordingly, this report does not provide assurance that the Firms' audits or reviews, or their clients' financial statements, are free of deficiencies not specifically described in this report.

Unless stated otherwise, not all matters in this report apply to every Firm and, where they do apply to more than one Firm, there will often be differences in degree. Our observations and findings relate only to the individual firms inspected and cannot be extrapolated across the auditing profession in Australia. Our observations and findings can differ significantly even between firms of similar size and for that reason we caution against drawing conclusions about any firms not yet inspected by ASIC.

Unlike some other jurisdictions, ASIC is also the securities regulator in Australia. This report covers inspections but does not include any matters arising from other regulatory activities such as investigations or surveillances in relation to the Firms or its clients, although these matters may inform focus areas in inspections.

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Executive summary

Overview of findings

1 This report covers audit firm inspections substantially completed in the period 1 January 2008 to 30 June 2009 as part of ASIC's audit inspection program. This report does not cover audits for the year ended 30 June 2009 or the results of ASIC's other activities relating to auditors (such as our financial reporting surveillance program, surveillances relating to identified concerns with individual audits, referrals to the Companies Auditors and Liquidators Disciplinary Board, and investigations in connection with corporate failures).

2 Australia's audit regime compares well internationally. Further, it was pleasing to see that Australian firms have taken steps since our last report to make further enhancements and refinements to their independence and audit quality systems and processes.

3 ASIC reviewed audit engagement files across 19 firms, focusing on the substance of the auditor's work and whether sufficient and appropriate audit evidence was documented to support the conclusions reached in relation to key audit judgements. Our audit inspection program has identified a number of cases requiring improvements in audit quality in audit areas related to the global financial crisis (GFC), such as appropriate use of experts in testing asset valuations. Our audit inspections also continue to identify a number of other matters to be addressed by firms, particularly in the areas of audit evidence and documentation for significant audit judgement areas.

4 We will continue to assess the overall performance of the auditing profession as we complete our inspection activities for the end of 2009 and 2010 and as the results of surveillances and investigations become known.

5 Different entities are affected differently in the current economic conditions. Auditors should continue to focus on areas such as going concern, impairment of assets, and determination of fair values of assets, as appropriate.

The inspection process

6 Unlike many other regulators internationally, ASIC is both an audit oversight regulator and a securities regulator. In addition to our audit inspection program, the results from which are the subject of this

report, we conduct a range of other activities that cover the work of auditors. These other activities include our financial reporting surveillance program, surveillances of individual audits, and investigations into corporate failures. While the focus areas in our inspection program are informed by these other activities, the inspection program does not duplicate these other activities. For example, we do not review audit files in our inspections relating to entities for which we are also investigating a corporate failure. Where serious concerns are identified with individual audits in an inspection, these matters are transferred to separate surveillance activities.

7 The results of our investigation and surveillance activities also reflect on firm audit quality. However, investigations and surveillances can take time to be resolved, including the results of court action and other appropriate actions. We will be in a better position to assess the performance of the audit profession during the GFC once the outcomes of those activities are known.

8 During 2009, we conducted more timely reviews of individual audit engagement files by performing those reviews closer to the completion of audit work. Previously reviews where conducted 12 months or more after audit completion. While our inspections have continued to focus on audit process matters, we have also placed emphasis on assessing the quality of audit risk assessments and judgements. Our file reviews focused on entities and areas most likely to be affected by the GFC.

9 Much of this report is split between national partnerships that are members of global networks with multiple offices (National Firms), individual offices of firms that are members of international associations (Network Firms) and firms with small number of audit partners that audit a limited number of listed entities (Smaller Firms).

Key findings—audit quality

10 Our audit inspections continue to identify a number of significant matters that need to be addressed by the firms, particularly in the areas of audit evidence and documentation for significant judgement areas. While there may be cases where the necessary audit evidence was obtained and proper consideration was given to significant judgement areas but not documented, there will also be cases where the necessary audit evidence and analysis to support the audit opinion was not obtained or performed. There may be no material misstatement in the audited financial report, but if evidence and analysis are not obtained or performed the auditor does not have a basis for their opinion. This

extends to evidence and judgements in areas most impacted by the GFC.

11 While the full implications and outcomes of the GFC, including the public outcomes of our investigations and surveillances, are still unknown, improvements are required by all firms in specific areas most affected by the current economic conditions such as going concern assessments, impairment of assets and fair value determinations. Further details of the implications of the GFC on the audit profession are provided in Section B.

12 There are instances where audit risk assessments have failed to identify key risks and where fundamental audit procedures have not been conducted. Even where there are no identified audit risks for particular transactions or balances, a basic level of testing is still required.

13 Even in focusing on risk areas identified by the Firms, our individual audit and review engagement reviews for Firms continue to reveal significant numbers of cases where there was a lack of sufficient appropriate audit evidence for judgements in key audit areas, documentation failed to provide enough evidence to support the conclusions reached or audit procedures were not adequately undertaken.

14 There continues to be a need for improvement by all Firms, particularly in the areas of audit evidence and documentation, reliance on another auditors' or experts' work, risk assessments (including risk of fraud), impairment testing, fair value measurements, related party transactions, going concern assessments and engagement quality control reviews.

Key findings—quality control

15 While the Firms previously inspected have made enhancements and refinements to audit quality systems and processes since our last public report, a key area of focus for National Firms continues to be the ongoing review and testing of quality control systems and ensuring that these systems remain relevant and robust, particularly in the context of risks associated with the GFC.

16 Some Network Firms have made good progress towards adopting common policies, systems and processes in respect of independence and audit quality within their practice. However, a number of Network Firms were in a transitionary phase in modifying their systems,

policies and processes to ensure uniformity in approach across member firms.

17 For Network Firms, it is critical that once common quality control policies and processes are fully embedded, an effective testing and monitoring regime is established to assess the effectiveness of quality control systems. Network Firms also need to establish clear linkages between partner remuneration and the results of quality monitoring reviews of both independence and audit engagements.

18 Our observations and findings for Smaller Firms related primarily to a failure to record on the audit engagement files all the work which the auditor performed and relied on in forming conclusions and, in some cases, failing to perform certain audit procedures.

19 Quality control areas that the Smaller Firms also need to focus on include formalising independence and monitoring processes to ensure compliance with the requirements of the *Corporations Act 2001* (Corporations Act) and professional and ethical standards.

Future focus

20 As the full effect of the GFC is still uncertain, our inspection approach continues to focus on relevant audit risk areas and how firms are addressing those areas.

21 Inspections will continue to focus on quality control systems and processes with a greater emphasis on engagement performance for those firms previously inspected. We will continue to focus on those firms that audit entities likely to be of greater public interest. We will also continue to focus on how firms are complying with the Auditing Standards and professional and ethical standards, paying particular attention to those Auditing Standards impacted more by the effects of the GFC and those that were poorly applied in previous years.

A The audit inspection program

Key points

There remains a need for improvement by the firms in relation to audit evidence and documentation, including in areas most affected by the GFC. The full implications of the GFC are still unknown.

We have observed that significant improvements in quality control systems and processes are made after our first inspection of a firm.

Objective

22 ASIC's audit inspection program aims to promote high-quality external audits of financial reports under Ch 2M of the Corporations Act of listed and other entities of greater public interest so that users can have greater confidence in financial reports. A strong audit profession helps maintain and promote confidence and integrity in Australia's capital markets.

23 The purpose of the inspection program is not to benchmark the Firms and firms are responsible for addressing any improvement areas identified.

24 Our audit oversight activities help maintain and raise the standard of conduct in the auditing profession. We focus on audit quality and promoting compliance with the requirements of the Corporations Act, Auditing Standards and Professional Ethical Standards. We do not seek to confirm the overall audit opinions.

25 Our inspection program has an education and compliance focus, although enforcement action will be taken where significant non-compliance is identified. Such enforcement actions are outside the scope of the audit inspection program and are referred to ASIC's Deterrence teams for further consideration and action.

GFC focus

26 The financial performance of many entities has been adversely affected by the global economic downturn. Our financial reporting surveillance media releases identify key financial reporting areas that have been significantly affected by the economic downturn. These media releases geared towards the accounting and audit profession,

are published on a regular basis and available on our website (www.asic.gov.au).

27 Inevitably, the GFC has placed increased focus on accountants and auditors who are part of the financial reporting chain, together with management, directors, audit committees, internal audit, and external experts.

28 The GFC has heightened the need for auditors to focus on assessing the appropriateness of the going concern assumption, particularly given reduced liquidity and ability of clients to refinance debt or raise new funds, and comply with lending covenants. Firms need to ensure that audit team members have sufficient skills to audit fair values and impairments, or the means to engage their own expert if necessary. In addition, the scope of an expert's work, whether internal or external, must be adequate for audit purposes. Auditors need to adopt an even higher degree of professional scepticism in challenging clients, particularly for significant audit judgement areas.

29 As part of our inspection program activities, during 2008–09, we also met with the senior leadership of the eight largest firms in Australia to discuss and assess each firm's preparedness for auditing in the GFC. The purpose of these meetings was to understand the range of measures and specific actions undertaken by these firms to manage the implications of the GFC for their audit activities.

30 Generally, the firms that we met had taken proactive steps to manage the risks associated with the GFC on their audit clients. Some of these steps included identifying and reassessing audit client risk ratings, appointing specialist panels for quality assurance purposes, adopting an increased focus on specialist consultations, providing additional specific technical training on areas of focus, and reassessing the allocation of partners and staff for higher-risk engagements.

31 As the majority of the 101 individual audit and review engagement files we selected for review at National Firms, Network Firms and Smaller Firms were for financial reporting periods between 30 June 2007 and 31 December 2008, we will continue to focus on the effectiveness of the above initiatives in our 2009–10 audit inspection program.

Improvements since previous inspections

32 The firms inspected continue to respond positively to the legislative and professional requirements by implementing robust systems and processes that are designed to ensure compliance with the audit

quality and auditor independence requirements of the Corporations Act, Australian Auditing Standards (ASAs) and Accounting Professional and Ethical Standards (APESs).

33 Most firms improve their quality control systems after the first inspection. In most instances, the results of the first inspection indicate that some quality control elements either have not been addressed by these firms, or many systems and processes have not been fully developed.

34 Subsequent inspections almost always show a marked improvement in most, if not all, areas identified in the first inspection receiving attention by the Firms' leadership. Many Firms have committed, and continue to commit, dedicated technical resources and, where required, have developed or further enhanced existing policies and systems to assist them in complying with legislative requirements. This trend was also observed in this cycle of inspections.

Changes to the inspection approach

35 A number of Firms meet the revised definition of a network firm contained in Accounting Professional and Ethical Standard APES 110 *Code of Ethics for Professional Accountants* (APES 110), applicable from 1 July 2008. We therefore changed our approach from individual Firm inspections to inspections of a number of member firms of a network. Five Firms were inspected under a network basis for the first time in this inspection cycle.

36 In 2008–09, we inspected four National Firms and nine Network Firms where we undertook full-scope inspections comprising the review of firm-wide procedures and review of individual audit and review engagements. We also extended our coverage, using a limited inspection scope, to include six Smaller Firms. We maintained the number of audit and review engagements selected for review compared to the previous inspection cycle, with particular focus on those entities with a heightened risk as a result of the GFC and those Auditing Standards that our previous inspections showed required continued attention.

37 Appendix 1 contains further details about how we conducted our work.

Scope of our audit inspections

38 This is the fourth public report on our audit inspection program since the enactment of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9) on 1 July 2004.

39 This report summarises the results of audit inspections of 19 audit firms (Firms) conducted over an 18-month period from 1 January 2008 to 30 June 2009. The Firms inspected range in size as follows:

(a) national partnerships that are members of global networks with multiple offices (National Firms);

(b) individual offices of Firms that are members of international associations (Network Firms); and

(c) firms with small number of audit partners that audit a limited number of listed entities (Smaller Firms).

40 A summary of our inspections of the Firms and whether they were inspected for the first time or more than once is provided in Table 1.

Table 1: Summary of firms visited in 2008–09

Firms	Inspected for the first time	Inspected more than once	Total
National Firms	—	4	4
Network Firms	8	1	9
Smaller Firms	6	—	6
Total	14	5	19

Note 1: For the eight Network Firms visited once, under the revised APES definition of a network firm applicable from 1 July 2008, five firms were inspected on a network basis with a number of member firms of the network being inspected. One of these networks had previously been inspected in 2007. Three individual member firms of other network firms were also inspected.

Note 2: The Network Firm visited more than once relates to a follow-up inspection of an individual member firm of a network.

41 This report is structured as follows:

(a) Section B sets out our observations and findings from the review of 95 audit and review engagements for National and Network Firms;

(b) Section C sets out our observations and findings on quality control systems from the reviews of National Firms and Network Firms;

(c) Section D details our observations and findings from the review of quality control systems and six audit engagement files from the Smaller Firm inspections;

(d) Section E outlines the future focus of the audit inspection program; and

(e) Appendix 1 provides information on how we conduct our work.

Previous inspection reports

42 In September 2005, we published our first public audit inspection report covering the 2004–05 financial year. This report assessed whether firms had documented and implemented a quality control system that provided reasonable assurance of compliance with the auditor independence requirements of the Corporations Act.

43 In 2005–06, we broadened our scope to assess whether firms' audit methodologies facilitated the conduct of audits in compliance with the audit quality requirements of the Corporations Act. Our second public report covering this extended scope was published in August 2006.

44 Our third public inspection report, published in June 2008, covered an 18-month period from 1 July 2006 to 31 December 2007. During this period, we continued to focus on the firms' independence policies, systems and processes, to assess compliance with the auditor independence requirements in Div 3, 4 and 5 of Pt 2M.4 of the Corporations Act and relevant professional and ethical standards.

45 This inspection report and previous reports are available on our website (www.asic.gov.au).

Diversity of Firms

46 As at June 2009, the National Firms audited approximately 900 (S&P 300–260) listed entities which accounted for 95% (S&P 300–97%) in terms of total market capitalisation.

47 Firms differ in areas such as size, nature, type of audit clients and risk management strategies. How each firm complies with its legal and professional obligations is affected by these factors.

48 Even among National and Network Firms there are differences in their size, structures, strategies, target markets, extent of centralised resources, international reach and risk management strategies. There are even greater differences when Smaller Firms are compared with

National and Network Firms. As a result, observations and findings varied between the National Firms, Network Firms and Smaller Firms.

49 Our inspection program for National Firms, Network Firms and Smaller Firms is appropriately tailored to recognise this diversity.

International collaboration

50 As noted in our last public report, ASIC entered into an arrangement with the US-based Public Company Accounting Oversight Board (PCAOB) on 17 July 2007 to assist the PCAOB ascertain compliance by Australian auditors with the *Sarbanes-Oxley Act of 2002* (US). Three inspections were conducted jointly with the PCAOB during the period covered by this report.

B Audit quality—National and Network Firms

Key points

There continues to be room for improvement by all firms with regard to:

- sufficiency and appropriateness of audit evidence and documentation;
- reliance on another auditor's or expert's work;
- risk assessments;
- impairment testing and fair value measurements;
- going concern assessment; and
- engagement quality control reviews.

Introduction

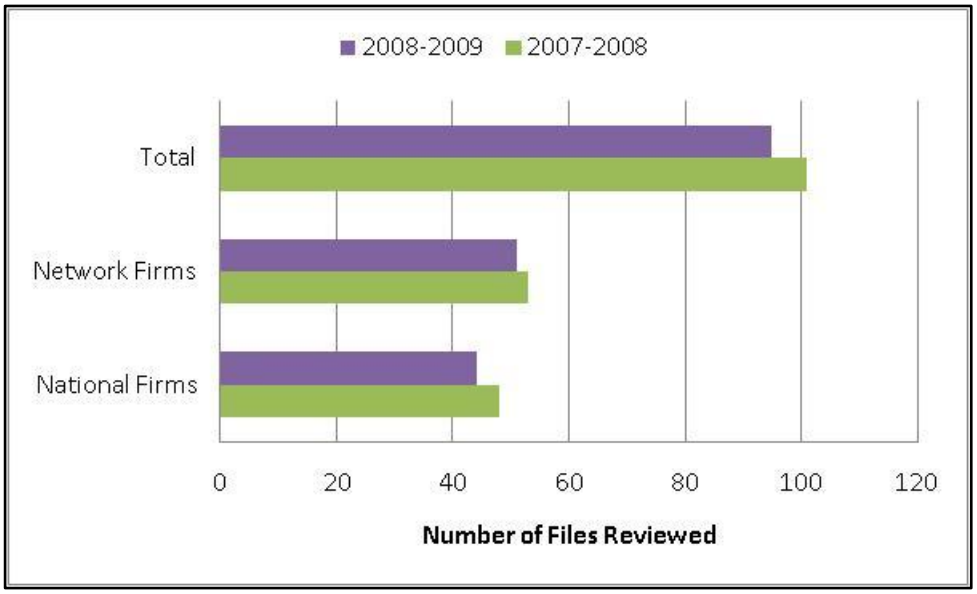
51 Our inspection program focused on the practical application of the Firms' audit methodologies. During the 18-month period covered by this report, we inspected 19 Firms and reviewed 88 audit and 7 review engagements across the National Firms and Network Firms. In comparison, during the period covered by the previous public inspection report, we undertook 82 audit and 19 review engagements.

Note: The 88 audit and 7 review engagements exclude 6 audit engagements that were reviewed as part of the Small Firm inspection program (see Section C).

52 Similar matters were noted in relation to National Firms and Network Firms from the engagement file reviews. For this reason we have not made a distinction between observations and findings that relate to National Firms or Network Firms in this section.

53 We only reviewed those engagements where the final assembly of the audit and the review engagement file has been completed by the firm. Auditing Standard ASA 230 *Audit Documentation* (ASA 230) ordinarily allows 60 days after the audit report date for the final assembly of the file to be completed. As such, the majority of the individual engagement files selected for review in Figure 1 were for financial reporting periods ending between 30 June 2007 and 31 December 2008.

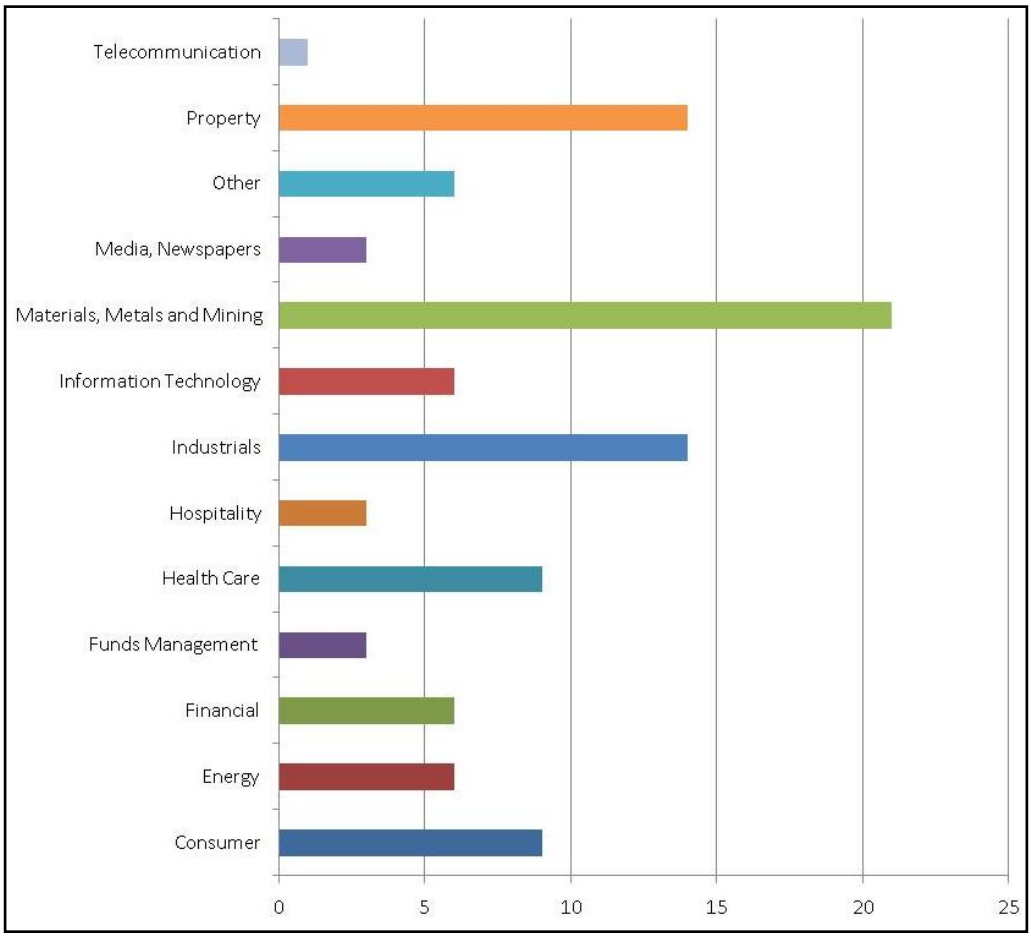
Figure 1: Number of engagement files reviewed by ASIC during public reporting years



54 The engagement file reviews focused on specific areas affected by current economic conditions. Each review focused on the substance of the auditor's work and on whether sufficient appropriate audit evidence was on file to support the conclusions reached in relation to key audit decisions and significant judgements.

55 Our file selections were spread across a number of sectors and based on entities perceived to be at heightened risk as a result of the economic downturn. A summary of the basis for selecting engagement files reviewed is provided in Figure 2.

Figure 2: Engagement files reviewed by sector 2008–09



Audit quality

56 Our review of aspects of the 95 selected engagement files at National Firms and Network Firms was designed to focus on audit quality to assess whether the key matters that contribute to an audit opinion or review conclusion had been adequately considered by the engagement team. It was not designed to detect all instances of non-compliance or to confirm all aspects of the audit opinion or the review conclusion.

57 Our reviews revealed a number of instances where documentation on the engagement file failed to provide sufficient appropriate audit evidence to support certain audit assertions. A lack of audit documentation meant there was a lack of sufficient appropriate audit evidence on the engagement file to support certain audit assertions, even allowing for oral explanations.

58 In some cases, the auditor failed to perform or to document certain mandatory audit procedures necessary to support the audit opinion or the review conclusion. In these cases, we challenged audit partners

regarding the basis on which significant judgements were made prior to their signing of the audit or the review report.

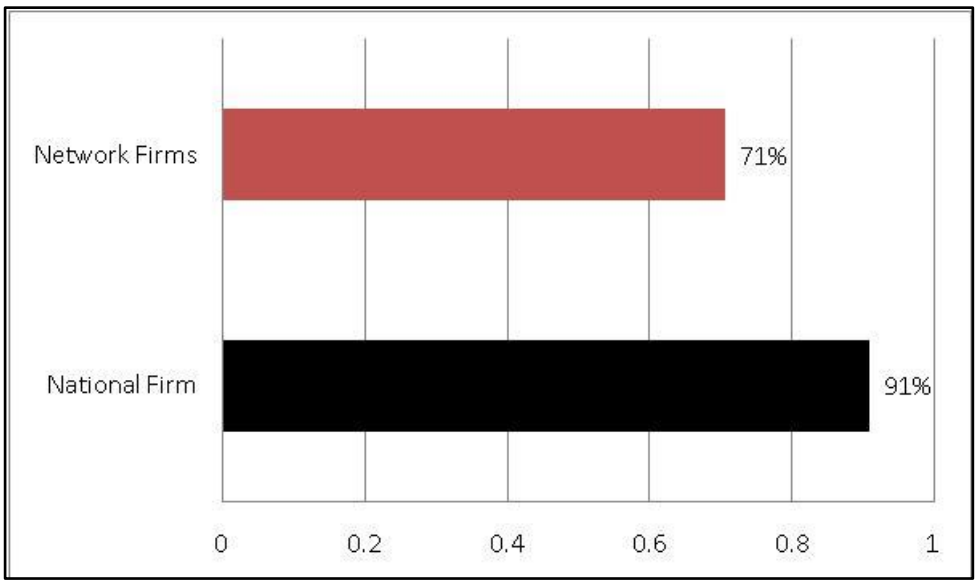
59 As a result of our discussions with the audit partners, in a few instances, further audit work was performed by engagement teams to confirm that the original judgements and conclusions were appropriate and that the financial report was not materially misstated.

60 Network Firms and National Firms continue to communicate our and their own internal monitoring findings regarding engagement files to individual engagement teams as well as the broader audit practice through technical training sessions, regular staff alerts and bulletins.

61 We have reported separately to each Firm in relation to these deficiencies and in some cases have accelerated our follow-up inspections of firms to ensure that corrective actions taken by the Firms are adequate.

62 The proportion of reviewed engagement files that contained sufficient appropriate audit evidence to support all key conclusions appears in Figure 3.

Figure 3: Percentage of engagement files which contained sufficient appropriate audit evidence to support key conclusions reached



Common observations and findings

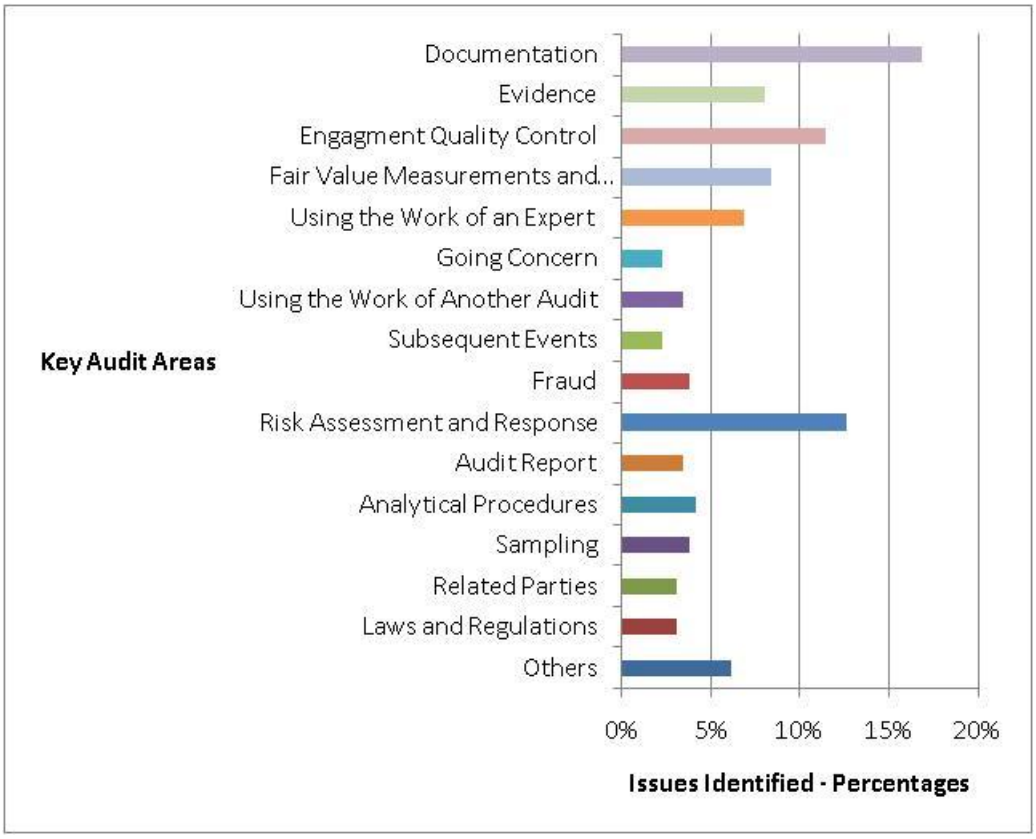
63 A summary of our observations and findings from the 95 engagements inspected at National Firms and Network Firms is provided in Figure 4.

64 This chart represents observations and findings in the key audit areas requiring improvement as a percentage of the total observations and findings from the 95 engagement files reviewed. These observations and findings are presented in two parts to reflect:

(a) matters that were frequently identified across the Firms and most significant in the context of the risks associated with the economic downturn; and

(b) other matters requiring improvement.

Figure 4: Observations and findings from engagement file reviews



Note: Figure 4 represents observations and findings in each key audit area as a percentage of the total observations and findings from the 95 engagement files reviewed.

Audit documentation and audit evidence

65 The Corporations Act requires audits to be conducted in accordance with the Auditing Standards. The same Auditing Standards were applicable for all 95 engagements selected for review.

66 Auditing Standards ASA 230 and ASA 500 *Audit Evidence* (ASA 500) require the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base their opinion. However, insufficient documentation of audit work

undertaken and the basis on which audit judgements have been made continues to be a major area of concern. Documentation deficiencies are pervasive across a number of areas noted in this section.

Lack of documentation and audit evidence

67 Matters relating to audit evidence and documentation accounted for 25% of the total issues noted in the 95 engagement files we reviewed. A number of these related to:

(a) inadequate documentation to support the audit procedures performed or the evidence obtained; and

(b) incomplete or late assembly of engagement files.

68 In most of these cases, there was a failure to record on the engagement file audit work which the auditor performed and relied on in forming their conclusions about key audit assertions. In these cases, there is a risk that the audit work was not adequately performed and that the conclusions reached were not appropriate.

69 In some instances, the auditor may have failed to perform certain procedures.

70 In the majority of cases, the auditor made verbal representations that the audit work had been performed but not documented.

71 Paragraph 13 of ASA 230 states that 'ordinarily, oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation'.

72 In addition a fundamental requirement of paragraph 11 of ASA 230 is that 'the auditor shall prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:

(a) the nature, timing, and extent of the audit procedures performed to comply with Auditing Standards and applicable legal and regulatory requirements;

(b) the results of the audit procedures and the audit evidence obtained; and

(c) significant matters arising during the audit and the conclusions reached thereon.'

Documentation must be timely

73 ASA 230 also requires timely preparation of audit documentation that provides a sufficient and appropriate record of the basis for the auditor's report and evidence that the audit was performed in

accordance with the Auditing Standards and applicable legal and regulatory requirements.

74 Timely documentation of audit procedures performed helps ensure the quality of the audit, and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the audit report is finalised.

75 In many cases, the engagement files were not assembled and completed within 60 days of signing of the audit report. Auditing Standard ASA 230 ordinarily allows 60 days after the audit report date for the final assembly of the engagement file to be completed.

Engagement quality control

76 In a number of engagement files there was a lack of evidence of reviews by the engagement partner and the EQCR partner and/or a lack of timely reviews. In particular:

(a) engagement partners or EQCR partners didn't identify a lack of sufficient appropriate audit evidence and documentation to support key conclusions reached;

(b) there were recurring or similar findings of deficiencies from the Firms' own internal quality monitoring processes;

(c) there was minimal documentation of high-risk areas and complex matters considered by the engagement partner and/or the EQCR partner at the planning and/or the completion phases of the audit; and

(d) time records for a number of engagements indicated that the EQCR partner spent or recorded less than 1% of the total time charged by the engagement team to the individual engagement, including instances where no time was charged by the EQCR partner.

77 ASA 220 requires that before the auditors' report is issued, through review of the audit documentation and discussion with the engagement team, the engagement partner shall be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

78 ASA 220 also requires an engagement quality control review for audits of financial reports of listed entities that includes an objective evaluation of the significant judgements made by the engagement team, and conclusions reached in formulating the auditor's report.

79 The involvement of a suitably-qualified EQCR partner at critical stages of the audit (including the review of audit planning and review of the engagement teams' key judgements and conclusions) is a vital element of quality control.

Fair value measurements and impairment

80 Auditing Standard ASA 545 *Auditing Fair Value Measurements and Disclosure* (ASA 545) requires the auditor to obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework. ASA 545 applies to fair value measurement for the purpose of impairment testing under the accounting standards and similar impairment calculations, such as 'value in use' calculations.

81 Values of many assets were affected by the economic downturn. Accounting standards have required enhanced disclosures of key valuation assumptions and sources of estimation uncertainty.

82 In a number of engagements reviewed, auditors failed to adequately document their consideration of whether client staff had the relevant expertise and experience to perform 'value in use' calculations in accordance with Accounting Standard AASB 136 *Impairment of Assets* as required by ASA 545 and whether there was a need to use the work of an expert. Similar issues were noted when financial models were utilised to determine fair values.

83 In some instances where there was a significant risk relating to the fair value of an asset, the auditors did not adequately document or challenge whether the key assumptions used by management provided a reasonable basis for measuring fair value and disclosures in the financial report.

84 Other common flaws observed included:

(a) lack of clarity in the audit working papers, which suggested the auditor did not understand the nature of the discount rate being used or the nature of the cash flows being discounted;

(b) the discount rate utilised not reflecting the risks specific to the asset;

(c) the use of high growth rate assumptions, both within and beyond explicit forecast periods, which were not adequately supported and in some cases very optimistic;

(d) poor documentation of sensitivity analyses performed by the engagement team to test management assumptions;

(e) failing to evaluate whether the disclosures about fair values made by the entity were in accordance with the relevant accounting standards;

(f) the client omitting an estimate of some key future cash flows which the company expected to derive from the asset; and

(g) failing to ensure that the 'value in use' calculation was consistent with other audit evidence obtained during the audit, including valuation cross checks.

Using the work of experts

External experts

85 Auditing Standard ASA 620 *Using the Work of an Expert* (ASA 620) requires an auditor to obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purpose of the audit. The auditor is also required to evaluate the expert's objectivity. The risk that an expert's objectivity may be impaired increases where the expert is employed by the client.

86 A number of engagement files we reviewed did not adequately document how the auditors met the requirements of ASA 620. Common deficiencies were:

(a) the lack of sufficient evidence on the engagement files that the auditor considered the professional competence and objectivity of the expert, the appropriateness of the expert's work as audit evidence, and the reasonableness of the source data used by the expert to confirm the integrity and consistency of the data used;

(b) some experts' work did not include independently assessing the reasonableness of key assumptions which underpinned the valuation and the audit documentation did not adequately address this key limitation of scope in the expert's work; and

(c) it was not always clear that an expert engaged to determine the discount rate had determined the rate having regard to the risks attached to cash flows, as required by the relevant accounting standard.

Internal experts

87 Due to the recent economic downturn, it is increasingly common for engagement teams to rely on internal specialists for key areas of work such as fair value measurement and asset impairment.

88 Although appropriate use of specialists should enhance audit quality, in some instances engagement teams accepted the work undertaken by specialists without an adequate review of the sufficiency and appropriateness of audit evidence obtained, including in some instances where specific restrictions on the scope of the specialists' work were not addressed.

89 Engagement teams need to ensure that work performed by specialists is fully-integrated into the audit process, and ensure there are no gaps in work by clearly agreeing on the scope of the work to be performed, clarifying respective responsibilities, and ensuring that the scope and conclusions are appropriately documented.

Going concern

90 Auditing Standard ASA 570 *Going Concern* (ASA 570) requires the auditor to consider the appropriateness of management's assessment of the entity's ability to continue as a going concern in the preparation of the financial report.

91 ASA 570 requires the auditor to undertake specific procedures when events or conditions have been identified, which may cast significant doubt on the entity's ability to continue as a going concern. This includes gathering sufficient appropriate audit evidence to confirm or dispel whether or not material uncertainty exists by performing audit procedures and considering the effects of management plans and other mitigating factors.

92 In a small number of engagement files, there appeared to be a lack of sufficient appropriate audit evidence supporting the auditor's consideration and evaluation of management's assessment of the entity's ability to continue as a going concern. We noted instances where key indicators such as cash flows for the next 12 months from the date of the audit report, were not considered by the auditor. In two instances, events or conditions casting doubt on the entity's ability to continue as a going concern had been identified but a modified opinion was not issued.

Using the work of another auditor

93 Auditing Standard ASA 600 *Using the Work of Another Auditor* (ASA 600) requires the principal auditor to consider the professional competence of the other auditor when planning to use the work of that auditor.

94 In a small number of the 95 engagement files reviewed, the work of another auditor was relied upon by the principal auditor. In many of these cases there was insufficient evidence on the engagement files that the auditor considered the professional competence of the other auditor.

95 Although most of the other auditors were part of the network firm, it is still necessary for the auditor to give appropriate consideration to their competency. While some firms had enquired about the results of the

internal quality reviews of the other audit firm, this was not part of the formal quality control process.

96 Other common deficiencies noted were a lack of sufficient appropriate audit evidence and/or documentation to evidence that:

(a) the work of the other auditor was adequate in a context of the subsidiary audit and complied with the Auditing Standards;

(b) the principal auditor had considered the impact of any substantial differences between the auditing and accounting standards where the entity audited by the other auditor is overseas; and

(c) all the work requested by the principal auditor in the interoffice or group instructions were actually received and/or reviewed by the principal auditor.

Subsequent events

97 Auditing Standard ASA 560 *Subsequent Events* (ASA 560) requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment or disclosure in the financial report are identified.

98 In a few engagement files reviewed, there was no evidence that adequate audit procedures had been performed to ensure that events up to the date of the auditor's report had been considered. In a number of instances, subsequent events work was performed, however, this was performed well before the date of the audit report.

99 In some instances, there was a lack of sufficient appropriate audit evidence on the engagement file to support that audit work had been performed prior to signing the audit opinion or review conclusion to fully determine the materiality of the subsequent event, and therefore to support conclusions relating to the non-disclosure of post-balance date events in the financial report. In other instances, although the directors' report contained disclosure on subsequent events, the audited financial reports did not contain similar disclosures.

Fraud

100 Auditing Standard ASA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report* (ASA 240) requires consideration of the risks of material misstatement in the financial report due to fraud in planning and performing the audit, and perform procedures to reduce audit risk to an acceptably low level.

101 Common issues noted in this area included a lack of robust documentation of fraud risk discussions within the engagement team during audit planning with those charged with governance.

102 In a number of instances, firms have implemented checklists or questionnaires to assist in ensuring compliance with the requirements of the standard. Although the checklists were generally completed by engagement teams, there was limited or no documentation on the engagement file supporting the risk factors identified and how audit procedures were designed to address those risks.

103 Contrary to the requirements of the standard, we also noted some instances where limited or no audit procedures were performed to identify and assess the risks of material misstatement due to fraud relating to revenue recognition.

Risk assessment and response

104 Auditing Standards ASA 315 *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* (ASA 315) and ASA 330 *The Auditor's Procedures in Response to Assessed Risks* (ASA 330) require understanding the entity and its environment, including its internal controls, and assessing the risks of material misstatement of the financial report (whether due to fraud or error), and designing and performing further audit procedures at the financial report and assertion levels in a financial report audit.

105 In a number of engagements reviewed, there was a lack of sufficient appropriate audit evidence on file to indicate that the requirements of the standards had been met. In some cases, there was no documented assessment and understanding of the entity and its environment, including its internal controls to identify and assess the risks of material misstatement of the financial report.

106 The requirements to assess the significance of identified risks during the planning process and reassessing those risks throughout and at the end of the audit were not complied with in some instances. Also, the identified risks were not linked to audit procedures designed to mitigate those risks in some instances.

107 Other non-compliances related to a lack of audit documentation to evidence that a review of accounting policies and an evaluation of the overall presentation of the financial report had been performed, and that material journal entries and other adjustments made during the course of preparing the financial report had been examined.

Form and content of audit reports

108 A number of audit reports for the engagements selected for review were not in compliance with the requirements of Auditing Standard ASA 700 *The Auditor's Report on a General Purpose Financial Report* (ASA 700) or the Corporations Act. For example, at one Network Firm we noted that several auditor's reports did not include an opinion on whether the remuneration report contained in the directors' report complied with the Corporations Act. At another Network Firm, we noted that some audit opinions were not signed under the correct name of the firm.

Other observations and findings

109 Our other observations and findings from the review of the audit and review engagement files are detailed below.

Analytical procedures

110 In a number of cases, analytical procedures used in the planning of the audit were not performed well, with limited or no predictive analysis undertaken and management data was utilised without adequate work to ascertain the reliability of the data.

111 Similarly, for substantive analytical procedures, it was common for engagement teams to document explanations provided by management without further independent corroboration of the explanations or reference to the auditors' own understanding of the entities' operations.

Sampling

112 In a small number of engagement files reviewed, we found instances of inappropriate sampling methods, inadequate sample sizes and poorly-documented rationales for selecting particular items for audit testing.

113 Further, the auditor's consideration of the sample results, the nature and cause of any errors identified and their possible effect on the particular audit objective on some engagements were not documented in the engagement file.

Related parties

114 Several engagement files had insufficient audit work in relation to the identification and assessment of related parties, related party

transactions and completeness of related party disclosures in the financial statements in accordance with the requirements of Accounting Standard AASB 124 *Related Party Disclosures*.

Laws and regulations

115 Several engagement files failed to demonstrate either an assessment of the client's compliance with laws and regulations or obtain specific representation from management regarding compliance with applicable laws and regulations.

116 In addition, at one Network Firm, we noted that the director's report (accompanying the audited financial report in the annual report) did not contain certain disclosures required by the Corporations Act.

C Quality control systems—National and Network Firms

Key points

Some National Firms need to improve the review and testing of their quality control systems, particularly in the context of auditor rotation.

Many Network Firms need to fully implement common quality control policies and processes.

Network Firms need to adopt an effective testing and monitoring regime to assess the effectiveness of their quality control systems.

Introduction

118 All firms need to have quality control systems in place that meets the requirements of Accounting Professional and Ethical Standard APES 320 *Quality Control for Firms* (APES 320) and Auditing Standard ASA 220 *Quality Control for Audits of Historical Financial Information* (ASA 220).

119 In assessing the firms' quality control framework we follow the elements set out in APES 320, being: leadership responsibilities for quality within the Firm, ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources, engagement performance and monitoring.

120 The following sections summarise ASIC's observations and findings for each of these elements with respect to National Firms and Network Firms inspected during 2008–09.

National Firms

Leadership responsibilities for quality within the firm

121 National Firms have policies and procedures designed to ensure audit quality and that audits are performed in accordance with legal and professional requirements.

122 Although the frequency of independence and audit quality messages appear to be adequate at all National Firms, the observations and findings from some National Firm's own monitoring processes and

our engagement file reviews were, in some cases, at odds with these messages.

123 National Firms should continue to ensure that appropriate leaders within their respective firms regularly reinforce the 'tone at the top' messages about audit quality and the consequences of non-compliance to partners and staff.

Ethical requirements and independence issues

Policies, systems and processes

124 All National Firms have implemented systems and processes to facilitate compliance with their independence policies, and many Firms continue to improve their policies and systems. National Firms' policies and procedures require partners and senior staff to disclose their investments on an interactive database which is automatically matched with a prohibited securities list.

125 Although the extent of testing performed by the National Firms on independence quality control systems varies between each Firm, the sample sizes for testing partner independence declarations on a periodic basis increased for all Firms in 2008–09.

126 Irrespective of the sophistication of the systems in place or the sample sizes tested by each National Firm, all National Firms' internal testing of compliance continued to reveal non-compliances with their independence policies and systems. It is important to note, however, that in some areas the National Firms' policies include requirements that go further than those of the Corporations Act.

127 The most common non-compliance with policy at some of the National Firms continued to be the failure of partners and staff to record all reportable investments and financial interests in the Firms' independence monitoring systems. This is despite the level of resources invested by the National Firms in their quality control infrastructure, and continuous reinforcement of independence requirements through training and communications to partners and staff from the Firms' leadership.

Auditor rotation

128 Four contraventions of the auditor rotation requirements of the Corporations Act were noted at two of the National Firms—three at one firm and one at another firm. These contraventions of the Corporations Act were identified by the firm's internal monitoring systems and disclosed to ASIC on a voluntary basis. In all cases, an

ineligible partner played a significant role either as an engagement partner or engagement quality control review partner in the audit of a listed client for more than five out of seven successive financial years.

129 The Firms' investigations into the root cause of these contraventions indicated that improvements were required to either the auditor rotation databases that captured the partner rotation information or other related internal monitoring processes. The leadership of each Firm took strong and timely action, including financial sanctions, against the partners involved. These National Firms also enhanced their rotation monitoring processes to reduce the possibility of further breaches.

Consultations

130 Some National Firms need to ensure that independence consultations are better documented so that potential independence threats are identified, escalated, and action is taken to reduce the threats to an acceptable level. National Firms increased the importance of compliance with independence requirements when evaluating partner performance, by imposing financial penalties for significant identified non-compliances.

Acceptance and continuance of client relationships and specific engagements

131 All National Firms have robust policies and processes for client and engagement acceptance and continuance, including allocating risk ratings to all audit clients. In response to the GFC, National Firms have increased their attention to managing the risks associated with accepting and retaining clients and have reassessed the ratings of individual clients and engagements.

Human resources

132 We reviewed the partner and staff evaluation and remuneration processes at all National and Network Firms to assess auditor independence and audit quality aspects.

133 National Firms have extensive human resource policies and procedures that give due recognition to audit quality, ethical principles, competence in staff and partner evaluation, remuneration and promotion procedures. However, the practical application of these policies and procedures can be further improved.

134 Some common observations from a limited sample of partner and staff performance evaluation documents reviewed at each National Firm

included the need to improve the sufficiency and uniformity of documentation regarding partner and staff performance reviews. There was a lack of transparent indicators linking compliance with independence policies and the results of internal monitoring reviews to partner remuneration and bonus allocations.

135 We also noted that some National Firms were not recording industry-specific training for staff. These National Firms need to implement processes to record industry-specific training to help identify staff with relevant industry knowledge for specialised and complex audit engagements.

Engagement performance

136 All National Firms continue to enhance their systems and processes to better integrate audit technology with their audit methodology. A number of Firms implemented, or are in the process of implementing, new audit technology systems.

Monitoring

Policies and procedures

137 All National Firms have comprehensive policies and procedures to govern the monitoring of independence and audit quality in accordance with legal and professional requirements. The Firms make regular and rigorous periodic inspections of a selection of completed audit engagements and the results are reported to their leadership team. Further, National Firms have clear accountable action plans for ongoing consideration and evaluation of their quality control systems and staff training.

Monitoring review findings

138 Overall, the processes developed and adopted by National Firms appear to be robust. However, in some instances, we noted that the types of issues identified through the internal quality review processes were very similar when compared with the previous year's monitoring results. This raises the question as to whether the Firms' program is an effective mechanism in changing partner and staff behaviour and whether the means of addressing recurring non-compliance were effective.

Timing or monitoring reviews

139 At some National Firms, there was a significant time delay between conducting audit work and the timing of internal quality reviews due

to the Firms' global quality monitoring timeframes. This may impact on audit quality due to a lack of timely remedial action in relation to individual engagements.

140 To prevent deficiencies similar to those detected in past reviews from being repeated in future engagements, prompt disciplinary action is required against partners and staff who fail to comply with the Firms' policies and procedures as well as other appropriate actions such as timely and effective staff training. Given that the timing of these reviews is governed by global policies, the affected Firms have put in place other initiatives and communication strategies to ensure that key messages from the quality reviews are provided efficiently to staff.

Reporting to ASIC

141 Some National Firms need to ensure they comply with their obligations under s311 of the Corporations Act to report contraventions and suspected contraventions of the Corporations Act to ASIC. These include contraventions in relation to the auditor independence requirements of the Corporations Act and significant non-compliances with Accounting and Auditing Standards.

Network Firms

Leadership responsibilities for quality within the firm

142 While all Network Firms have indicated their commitment to audit quality during our inspections, there is a clear need to further strengthen their policies and procedures that promote the recognition of audit quality in performing engagements and the consequences of non-compliance with these policies and procedures.

143 The Network Firms' leadership need to clearly communicate and demonstrate an internal culture and tone that emphasises the overriding importance of audit quality, including in strategic plans or other similar documents.

144 Network Firms can further demonstrate 'tone at the top' by ensuring that transparent linkages exist between their monitoring processes for audit quality, auditor independence, partner and staff evaluation and remuneration processes.

Ethical requirements and independence issues

Policies, systems and processes

145 The completeness and adequacy of independence policies varied among Network Firms. In particular, a number of Firms were still in a transitionary phase in modifying their systems, policies and processes to ensure uniformity between member firms. Therefore we were unable to assess the operating effectiveness of policies and procedures over an extended period of time at these firms. In some instances, we noted inconsistencies in policies and the practical application of systems and processes at Network member firms.

Testing of independence systems

146 With the exception of two Network Firms, testing the independence systems and processes used to ensure compliance with their legal and professional independence requirements had not commenced at Network Firms. For one of the two Network Firms that is testing its independence systems, the program is not comprehensive and the Network Firm did not deal with identified breaches arising from its testing process in a timely manner.

147 Without a robust testing program, only limited reliance can be placed by Network Firms on the effectiveness of their independence systems and processes.

Auditor rotation

148 Based on the size and nature of their listed audit client portfolios, Network Firms do not have sophisticated systems to monitor compliance with the auditor rotation requirements of the Corporations Act. However, some of the more common findings for some of the Network Firms included:

(a) no documented auditor rotation plan;

(b) rotation plan not updated to reflect recent partner movements; and

(c) the engagement quality control reviewer (EQCR) not included in rotation plans.

Consultation

149 In addition, some Network Firms lacked formal processes to record and monitor independence consultations and ensure that any potential independence threats were identified, documented and action taken to reduce the threats to an acceptable level.

Acceptance and continuance of client relationships and specific engagements

150 While no significant systemic issues were noted, many Network Firms need to make their client acceptance and engagement continuance systems and processes more comprehensive and rigorous. Appropriate consideration needs to be given to the risk assessment process, including implications of significant changes in the risk profile of existing clients. This should take into account the integrity of key management personnel, including their attitudes toward aggressive interpretation of accounting standards and the importance of an internal control environment, business reputation, its operations and practices and inappropriate limitation in the scope of audit work.

151 The primary focus should continue to be on independence considerations, possible conflicts of interests and whether the firm continues to have the requisite skills to conduct an engagement.

152 In some instances, we noted that detailed consideration of whether to continue with an existing audit engagement occurs after a firm has been appointed as the auditor at the client's annual general meeting and in some instances after the audit planning has commenced or been completed.

153 Network Firms need to ensure that continuance assessments are made immediately after completing an audit so that the decision to discontinue with the engagement can be communicated in a timely manner to the client prior to reappointment at the annual general meeting and consent to resign from ASIC is obtained in accordance with the Corporations Act and the timing outlined in ASIC policies.

Human resources

154 Most Network Firms do not have appropriate policies and procedures to adequately consider audit quality and independence attributes in partner performance evaluations, and many Network Firms do not document partner evaluations. Policies and procedures should be documented to ensure that partners and staff are aware of the Firm's expectations regarding audit quality and ethical principles.

155 Clear understanding of audit quality and adherence to ethical principles should be key criteria for advancement and remuneration decisions. Failure to comply with these criteria should result in disciplinary and other appropriate action, such as training.

156 An adequate system of performance appraisals needs to be in place in order for partners and staff to receive meaningful feedback on their

performance, including advice on areas of improvement and additional training needs.

157 Completion and approval of appraisal documentation for both partners and staff should be on a timely basis to promote audit quality. In addition, the results of internal and external quality monitoring processes and outcomes of the Firms' independence testing should be incorporated into individual performance evaluation and remuneration.

Engagement performance

158 Some Network Firms are yet to develop or implement comprehensive audit manuals that provide practical guidance on Auditing Standards and application of the audit firm's software to ensure clarity and consistency in the conduct of audit work. Gaps were noted between some Firms' audit technology software and audit manuals, which resulted in inconsistent application of electronic work paper methodology across members of Network Firms. Examples of shortcomings in engagement performance policies and their application at some Network Firms include:

(a) lack of an up-to-date audit manual to provide staff with practical guidance on the Firm's interpretation of the Auditing Standards and the use of audit technology to ensure clarity and consistency in conducting audit work;

(b) no clear guidance in the existing audit manual on the roles and responsibilities of the EQCR, including the extent, timing and documentation requirements of the EQCR in accordance with ASA 220;

(c) no policy in audit manual regarding final assembly and archiving of audit engagement files, audit documentation requirements and inadvertent loss of engagement files;

(d) inconsistency in the use of audit methodology and technology between member firms of the same network; and

(e) non-utilisation of standard security features of the audit technology systems to enhance integrity of the engagement file (e.g. passwords and lockdown features not utilised, log of changes made to working papers and the function to back date and post date sign-offs not active).

Monitoring

159 Most Network Firms need to strengthen policies and procedures that facilitate monitoring of independence and audit quality requirements

to ensure they are relevant, adequate, operating effectively and are complied with in practice. Many Network Firms need to formalise internal monitoring policies and procedures by having clear guidance on the frequency of reviews, selection of audit files, and communication of the results of the reviews and consequences for partners and staff if the Firms' policies on audit conduct are not complied with.

160 While some Network Firms had commenced their periodic review of engagement files as required by their policy, others had not commenced these reviews. APES 320 requires periodic inspection of a selection of completed audit engagements.

161 A number of Network Firms need to adopt formal policies and procedures to deal appropriately with internal complaints and allegations of non-compliance with professional standards, regulatory and legal requirements.

162 All Network Firms need to improve their processes to ensure a clear and transparent link exists between the results of internal quality monitoring of engagement files and partner performance evaluations and remuneration.

D Smaller Firms

Key points

Smaller Firms need to focus on formalising their independence and quality monitoring processes.

Sufficient appropriate audit evidence, documentation of audit work undertaken and the basis on which audit judgements were made should continue to be major areas of focus for the Smaller Firms.

Introduction

163 There are approximately 90 small audit firms that audit entities listed on the Australian Securities Exchange (ASX). In 2008–09, we expanded our inspection program to include a selection of six Smaller Firms auditing entities listed on ASX.

164 Due to the size, client profile and nature of these firms, we used a limited inspection scope. Our inspections were limited to reviewing one listed entity audit engagement file for each firm selected and enquiring about aspects of the firm's systems of quality control as they related to that engagement.

Audit quality

165 The observations and findings from our review of aspects of six selected engagement files indicated a general need to improve the level of documentation to evidence compliance with the Auditing Standards.

166 Smaller Firms also need to ensure that an adequate engagement quality control review is conducted for audits of financial reports of listed entities, while also managing the auditor rotation requirements of the Corporations Act. Such reviews should be conducted on a timely basis at appropriate stages during the audit, not only at the concluding stages, so that significant matters can be appropriately addressed.

167 In at least half of the six engagements reviewed, we noted the following concerns.

Evidence and documentation

168 We noted instances where the selected engagement file failed to provide enough audit evidence to support key audit assertions.

169 The deficiencies noted primarily related to a failure to record on the engagement file all of the audit work that the auditor asserted to have performed and relied on when forming conclusions about key audit assertions. These deficiencies increased the risk that the audit work was not adequately performed and that the conclusions reached were not appropriate.

170 Sufficient documentation of audit work undertaken and the basis on which audit judgements have been made should continue to be a major area of focus for Smaller Firms.

Use of experts

171 Some of the Smaller Firms inspected did not fully adhere to the requirements of the Auditing Standards concerning the use of experts when placing significant reliance on the work performed by a client-appointed expert. In some instances:

(a) no evaluation of the professional competence and objectivity of the expert was performed; and

(b) there was insufficient evidence on the engagement file that the auditor had considered whether the scope of the expert's work provided adequate audit evidence and could be relied upon for the purpose of the audit.

Risk and fraud assessment

172 The risk assessments performed for the selected engagements were often not in compliance with the requirements of the Auditing Standards. The auditors did not link the identified risks to audit procedures designed to mitigate these risks, including fraud risk assessment procedures. Smaller Firms should ensure that:

(a) proper identification and assessment of the significance of identified risks is undertaken during the planning process and a reassessment of those risks occurs during and at the end of the audit; and

(b) audit procedures are designed to adequately address significant risk areas identified.

Analytical procedures

173 Analytical procedures were either poorly or not completed by all of the firms. The Auditing Standards require analytical procedures to be applied as risk assessment procedures at the planning stage and in the overall review at the end of the audit. Smaller Firms should ensure that where management data is utilised, adequate work is performed on the reliability of the data, and management explanations for significant variances in financial statements are in accordance with the auditor's own understanding of an entity's operations.

Quality control systems

174 In conducting our inspections and in making our observations and findings, we are conscious of the size and nature of the Smaller Firms.

175 Our Smaller Firm inspections did not include a full review of firm-wide quality control systems. Rather, it was designed to ascertain the quality of audit conduct at Smaller Firms.

176 Our consideration of compliance by Smaller Firms' with the independence requirements of the Corporations Act and relevant professional and ethical standards was limited to high-level discussions with the Firms' leadership and considering independence matters relating to the individual audit engagement file selected for review.

177 Although our inspection of the Smaller Firms did not identify any independence breaches, Smaller Firms need to review their professional, ethical and statutory requirements in relation to independence and quality control to ensure they comply with their obligations, including the auditor rotation obligations under s324DA of the Corporations Act. For the Smaller Firms inspected we noted that:

(a) Half of the firms did not have an annual independence confirmation process for assurance personnel to confirm their compliance with independence policies and procedures, as required by paragraph 23 of APES 320.

(b) Two firms did not have established policies and processes for the approval of non-audit services to audit clients prior to the service being provided as required by paragraph 290.158 of APES 110.

(c) Two firms were at a greater risk of breaching the auditor rotation requirements under the Corporations Act due to the limited number of audit partners within their respective audit practices. These firms should consider partner succession planning to

ensure they are able to continue to comply with the auditor rotation requirements of the Corporations Act.

(d) Most of the firms did not have established policies and processes relating to the monitoring of system of quality control, including performing periodic inspection of their selected completed engagements as required by paragraph 74 of APES 320.

E Future focus

Key points

Our future focus will include:

- conducting inspections of those firms that audit significant public interest entities, focusing on risks arising due to the GFC;
- follow-up the extent to which matters noted in our previous inspections have been addressed, with an emphasis on performing engagement file reviews, particularly in relation to significant audit judgement areas;
- monitoring the impact of regulatory developments in auditing;
- ongoing engagement with firms on the future inspection reporting process and audit quality initiatives; and
- continued collaboration with foreign regulators to minimise the regulatory burden on Australian firms.

Overall scope

178 The focus of our audit inspection program will continue to be those firms who audit entities likely to be of greater public interest.

179 As in prior years, we will conduct follow-up inspections of firms visited for the first time during 2008–09 to ensure that prompt and appropriate action is being taken to address our observations and findings. We will also conduct follow up inspections of some other firms previously inspected and will continue to extend our inspections to Network Firms and Smaller Firms that have not previously been subject to an audit inspection.

Audit quality and evidence

180 Auditor independence and audit quality are important contributors to confidence in financial reports. Particularly given the concerns noted in this report, we will also continue to focus on specific areas most affected by the current economic conditions such as going concern assessments, impairment of assets, fair value determination, off-balance sheet arrangements, and financial instrument disclosures.

181 We will continue to focus our attention on engagement file reviews, paying particular attention to basic audit procedures and those Auditing Standards that have been poorly applied in previous years. Reinforcing the need for robust documentation to support the conclusions reached in relation to key decisions and significant

judgements regarding an audit will continue to be an area of focus for our inspections. If there is no documentation on file, the presumption must be that the auditor did not obtain the necessary audit evidence.

182 Other specific areas that we intend to focus on include:

(a) internal quality control processes and risk assessments undertaken to identify clients with heightened risk;

(b) understanding the business model and risk assessment for individual engagements;

(c) monitoring and examining the causes of recent corporate collapses, especially where they relate to auditor matters and focusing on these areas in our future audit inspections;

(d) monitoring the involvement of the EQCR at different stages of the audit, including consultations held with the engagement team and review of the key judgements and conclusions reached;

(e) sufficient appropriate audit evidence and documentation recorded on engagement files to support the significant judgements made by auditors in reaching their conclusions and framing their audit opinions;

(f) monitoring of the adequacy and timeliness of s311 statutory reporting obligations of the Corporations Act when auditors have reasonable grounds to suspect a significant contravention; and

(g) compliance with the auditor rotation requirements of the Corporations Act, given the contraventions noted for some of the firms inspected.

183 Our audit file reviews will include a focus on entities most likely to be impacted by current market conditions. We will also focus on audit quality for new or existing audits where audit fees appear low or appear to have been reduced for reasons other than changes in the underlying business of the entity being audited.

Compliance with new requirements

Clarity standards

184 In Australia, audits conducted under the Corporations Act must comply with Auditing Standards issued by the Auditing and Assurance Standards Board (AUASB), which are based on International Standards of Auditing (ISAs).

185 A comprehensive program was initiated in 2004 by the International Auditing and Assurance Standards Board (IAASB) to enhance the quality

and consistency of global audit practice through applying a new 'clarity' format to all ISAs. This project was completed in December 2008. The ISAs have also been substantively revised.

186 The revised and redrafted Australian Auditing Standards based on the international clarity standards will be operative for audits of financial reports with reporting periods commencing on or after 1 January 2010. Firms need to invest time and resources in understanding the new requirements of these new standards and ensure their audit methodology meets the new requirements. We will continue to monitor compliance with legally-enforceable Auditing Standards.

Australian Standards on Quality Control (ASQC 1)

187 The AUASB has issued Auditing Standard ASQC 1 Quality Control for Firms that Perform Audits and Reviews, of Financial Reports, Other Financial Information, and Other Assurance Engagements (ASQC 1). Systems of quality control in compliance with this Auditing Standard are required to be established by 1 January 2010.

188 ASQC 1 is a new pronouncement of the AUASB and is based on the international equivalent, International Standard on Quality Control (ISQC 1 Quality Controls for Firms that Perform Audits and Reviews of Financial Reports, and Other Assurance and Related Services Engagements) issued by the International Ethics Standards Board (IESBA) for Accountants, which is in itself the basis for APES 320 issued by the Accounting Professional and Ethical Standards Board (APESB).

189 Firms should not need to implement new quality control processes, as they should already comply with the requirements of APES 320, but should be mindful of any changes resulting from changes to ISQC 1. Our inspections and inspection reports already cover compliance with the requirements of APES 320.

Revised international ethical standards

190 The IESBA has released a new *Code of Ethics for Professional Accountants*. The effective date for the revised code is 1 January 2011 subject to some transitional provisions. The revised code is being considered by the APESB.

191 The revised international code extends the current rotation provisions to all key audit partners in addition to engagement and review partners and extends partner rotation requirements from listed entities to include all other public interest entities. The revised international code also further strengthens some of the requirements relating to the provision of non-assurance services to audit clients.

192 We will monitor the effect of any changes to the existing Australian professional code (APES 110).

Our audit inspection process

193 We continually review our audit inspection process to ensure that it is effective and focuses on current risk areas. From 30 June 2009 file reviews we are placing emphasis on assessing the quality of the auditor's understanding of the auditee's business, risk assessments and audit judgements. We are also performing more timely file reviews. We are considering further changes in the nature and extent of our file reviews and other inspection processes, including a focus on the performance of basic audit procedures as well as risk areas.

194 We also monitor developments in inspection processes in other international jurisdictions that have independent programs to ensure that our inspection reporting process remains effective.

Other work

Drivers of audit quality

195 While we acknowledge that assessment of audit quality is subjective, we intend to continue to engage with firms to discuss factors that impact on audit quality. We understand that these factors will vary between firms. We will continue to obtain statistical data from firms on existing financial and non-financial performance measures to assess factors that could impact on audit quality.

International collaboration

196 We will continue to work with our international audit regulation counterparts in order to reduce any regulatory overlap. Where possible, we will concentrate on maximising cross-border recognition opportunities and establishing regulatory cooperation arrangements.

197 Our contribution and participation at the International Forum of Independent Audit Regulators (IFIAR) and the International Organisation of Securities Commissions (IOSCO) will continue to ensure that our inspection techniques and process remains current and relevant with the changing global financial economy.

198 We will continue to actively monitor future developments in auditing and will respond to trends and issues through our inspection process and other targeted project work.

Appendix 1: How we conducted our work

199 This report covers inspections of Firms substantially completed between 1 January 2008 and 30 June 2009. The nature of our monitoring approach means that inspections were spread throughout the period, with inspections starting and concluding at some Firms earlier than at others.

Our monitoring approach

National Firms and Network Firms

200 We focused on assessing whether each Firm had documented and implemented a quality control system that provides reasonable assurance that:

(a) the Firms comply with the auditor independence requirements in Div 3, 4 and 5 of Pt 2M.4 of the Corporations Act (i.e. independence); and

(b) the Firms' audit methodologies facilitate the conduct of their audits in accordance with the Auditing Standards as required in Div 3 of Pt 2M.3 of the Corporations Act (i.e. audit quality).

201 It is not the purpose of our inspection program to benchmark the Firms or to make specific recommendations on how to improve independence or audit quality policies and systems. However, during our inspection, we highlighted to each Firm some suggested areas for improvement.

202 In particular, we considered the following areas in respect of each of the Firms' quality control systems:

(a) executive leadership;

(b) independence;

(c) acceptance and continuance;

(d) human resources;

(e) engagement performance; and

(f) monitoring.

203 Our inspections concentrated firstly on reviewing each Firm's independence systems and processes, including examining each Firm's testing results. We conducted only limited testing of each Firm's systems.

204 Second, we examined each Firm's audit methodology for compliance with Auditing Standards operative for financial reporting periods commencing prior to the date of our inspection.

205 Third, we reviewed the conduct of aspects of a limited number of archived individual audit and review engagements for compliance with each Firm's stated audit methodology and applicable Auditing Standards as at the date of each audit or review. We also focused on specific areas most affected by the current economic conditions. Each review concentrated on the substance of work and on whether sufficient appropriate audit evidence was on file to support the conclusions reached in relation to key decisions and significant judgements about the audit.

206 Our work programs are tailored to focus on key risk areas for each audit. They are not designed to find minor instances of non-compliance. We challenged audit partners regarding the basis on which significant judgements were made.

Smaller Firms

207 To reflect the size and client profile of smaller audit practices, our inspection approach is limited compared with inspections of National Firms and Network Firms.

208 A limited inspection of a Smaller Firm comprised:

(a) conducting a review of aspects of one archived audit engagement file of a listed entity for compliance with each Firm's stated audit methodology and applicable Auditing Standards as at the date of each audit or review; and

(b) holding discussions with leaders, engagement partners and other senior members of the engagement team (for the file selected) regarding the engagement file reviewed and certain policies and procedures relating to auditor independence and audit quality employed by the Firm.

209 The inspection process is not designed to gain a comprehensive understanding of the Firms' quality control systems, but rather, focus on the quality of audit conduct. Enquiries were in the context of observations specific to the engagement reviewed and therefore, may vary across firms where different risks are identified.

210 Smaller Firm engagement file reviews were mainly conducted at our offices, with on-site activities limited to discussions with Firms' personnel at the commencement and the completion of the inspection.

The inspection process

211 The inspection process was designed to gain an understanding of:

(a) the Firms' executive leadership direction and strategic priorities in relation to independence and audit quality;

(b) the Firms' policies and systems for ensuring audit quality and compliance with their independence obligations;

(c) the Firms' independence and audit methodology training programs;

(d) the links between the Firms' independence and audit quality policies and the performance management processes; and

(e) internal monitoring programs conducted by the Firms.

212 In conducting our inspections, we:

(a) reviewed material provided by the Firms under notice pursuant to the *Australian Securities and Investments Act 2001* (ASIC Act);

(b) reviewed the Firms' systems and processes for managing compliance with the audit independence requirements of the Corporations Act and for ensuring audit quality;

(c) reviewed aspects of a selection of archived audit and review engagements at each Firm, weighted towards listed entities;

(d) interviewed selected partners holding leadership roles in the Firms;

(e) interviewed selected human resources representatives;

(f) interviewed a number of the Firms' other partners and staff; and

(g) in the case of National Firms, visited some of their capital city offices and interviewed selected partners and staff.

Key terms

Term	Meaning in this document
AAC	Authorised Audit Company
APES	Accounting Professional and Ethical Standards
ASA	Australian Auditing Standards issued by AUASB pursuant to s336 of the Corporations Act
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Commission Act 2001*
ASX	Australian Securities Exchange
AUASB	Auditing and Assurance Standards Board
CLERP 9	*Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*
Corporations Act	*Corporations Act 2001* including the Corporations Regulations 2001 made for the purposes of that Act
EQCR	Engagement Quality Control Reviewer
IAASB	International Auditing and Assurance Standards Board
IFIAR	International Forum of Independent Audit Regulators
ISA	International Standards of Auditing
National Firms	National partnerships that are members of global networks with multiple offices
Network Firms	Individual offices of Firms that are members of international associations
PCAOB	Public Company Accounting Oversight Board of the United States of America
RCA	Registered Company Auditor
Smaller Firms	Firms with small number of audit partners that audit a limited number of listed entities

APPENDIX 5

Sample Checklist to determine whether [TO INSERT NAME OF AUDITOR INDEPENDENCE LEGISLATIVE PROPOSAL] is consistent with the public interest from the perspective of private interest theory

No.	**INTEREST GROUP**	**COST** **(Including $ estimates where possible)**	**BENEFIT** **(Including $ estimates where possible)**
1	Primary users of accounting information[785]		
2	Accounting Associations[786]		
3	Big 4 Firms[787]		
4	Middle Tier Firms[788]		
5	Small Firms[789]		
6	Managers of Companies[790]		
7	Accounting Professional & Ethical Standards		

[785] The primary users of accounting information consist of individual investors and those in the financial community who rely on the objectivity and integrity of auditors in order to invest on behalf of these individual investors.
[786] The members of the Australian accounting professional bodies being the CPA Australia, the Institute of Chartered Accountants in Australia and the Institute of Public Accountants (formerly known as the 'National Institute of Accountants').
[787] The Big 4 Firms are Deloitte Touche Tohmatsu, Ernst & Young, KPMG Australia and PricewaterhouseCoopers.
[788] Middle Tier Firms are firms (other than the Big 4 Firms) that have a mix of listed and non-listed entities as audit clients.
[789] Small Firms have audit clients that generally comprise of non-listed entities which by virtue of their size and nature of business, do not require as many audit staff and specialised audit experience to complete the audit.
[790] These consist of companies that produce financial information for external users.

No.	INTEREST GROUP	COST (Including $ estimates where possible)	BENEFIT (Including $ estimates where possible)
	Board Limited		
8	Australian Securities and Investments Commission		
9	Australian Securities Exchange Ltd (formerly known as the Australian Stock Exchange Ltd)		
10	Auditing & Assurance Standards Board		
11	Companies Auditors and Liquidators Disciplinary Board		
12	Financial Reporting Council		
	CONCLUSION[791] [TO INSERT THE NAME OF THE INTEREST GROUP(S) THAT STAND(S) TO DERIVE THE MOST BENEFIT FROM THE LEGISLATIVE PROPOSAL]		

[791] In circumstances where it is concluded that the primary users of accounting information are not the main beneficiaries of the legislative proposal, further investigation may need to be made into the merits of the relevant proposal in order for it to be considered as consistent with the public interest.

TABLE OF SUMMARY OF FINDINGS AND RECOMMENDATIONS

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
1	*Expanded FRC* *The Government will expand the responsibilities of the FRC, which currently oversees the accounting standard setting process, to oversee auditor independence requirements in Australia*.	The Accounting Associations and Big 4 Firms successfully lobbied to maintain the Accounting Associations' influence in the enforcement of auditor independence requirements. ASIC was successful in its lobbying efforts to maintain its influence in the enforcement of auditor independence requirements.	The FRC's responsibility for the direct monitoring of the auditor independence requirements in Australia has been delegated to ASIC. The self-regulatory approach advocated and supported by the Accounting Associations is not in the public interest as the appearance of independence is still compromised. This is because a reasonable person will conclude that it is difficult for the Accounting Associations to be impartial in the enforcement process when there is a conflict of interest.	In order to address this conflict of interest, it is prudent for another entity such as ASIC to be involved in the enforcement process rather than placing this responsibility solely on the Accounting Associations. ASIC however must be seen to be actively enforcing these requirements.
		The Accounting Associations, Big 4 Firms, Middle Tier Firms and the APPC influenced the development of the FRC to focus on oversight and not direct monitoring of the auditor independence requirements in Australia by limiting the FRC's	As above.	As above.

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
		responsibilities to providing strategic policy advice to the Treasurer. The proposal by the Financial Reporting Council for an expanded FRC role to include the monitoring of the auditor independence requirements was disregarded.		
		The Accounting Associations, Managers of Companies (Producer Group) and ASX have had an influence in the development of the composition of the memberships of the FRC.	The current membership of the FRC is comprised of 16 members. The CPA, the Institute, the IPA and the ASFA are represented on the FRC. The ASIC Act provides the Treasurer with a wide discretion that can support the appointment of FRC members from key stakeholder groups in addition to those that are appointed independently and are not	The ASIC Act should be amended to ensure that FRC members are appointed from key stakeholder groups in addition to those that are appointed independently and are not associated with such groups.

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
			associated with such groups. Ideal auditor independence means that the FRC should include members that do not have ties to interest and/or lobby groups.	
2	*General Statement of Principle requiring Independence* *The Government will amend the Corporations Act to include a General Statement of Principle requiring the independence of auditors.*	The Accounting Associations, Big 4 Firms, Middle Tier Firms and the ASX supported the general definition of auditor independence but were of the view that the definition of auditor independence in the accountants' ethical code of conduct should be the definition adopted in CLERP 9. This view was also shared by the External Commentators.	The Corporations Act stipulates a general requirement for auditor independence and prohibits an auditor from auditing in specific circumstances. The Accounting Associations were not successful in their lobbying efforts in this regard as their ethical code of conduct was not adopted in CLERP 9 and neither were the International Federation of Accountants rules on auditor independence.	Unsuccessful lobbying. No amendments required.

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
3	*Annual Declaration by Auditor* *The Government will amend the law to require the auditor to make an annual declaration that they have maintained their independence*.	The Accounting Associations and the Managers of Companies (Producer Group) were successful in their lobbying efforts in the development of the content for the auditor's independence declaration. This view was also shared by the Legal Practitioners and the External Commentators.	The Corporations Act requires an auditor to provide a written declaration that to the best of the auditor's knowledge, the auditor has not contravened any of the auditor independence requirements of the Corporations Act and any applicable code of professional conduct and that any contravention is to be set out in the declaration. It is in the public interest for auditors to adhere to applicable codes of professional conduct as this creates expectations of professional behaviour that are aimed at benefiting the public. It is also in the public interest for the Corporations Act to allow for the issuing of a qualified declaration to enable the auditor to provide a declaration that states the circumstance of any breach as this provides assurance to investors of the integrity of audited financial statements which in turn supports ideal auditor independence.	No amendments required.

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
4	*Employment Relationships* *The Government will amend the law to strengthen restrictions on employment relationships between an auditor and the audit client. This will include a mandatory period of 2 years following resignation from an audit firm before a former partner who was directly involved in the audit of a client can become a director of the client or take a position with the client involving responsibility for fundamental management decisions.*	The Accounting Associations, Big 4 Firms and ASX were successful in their lobbying efforts to limit the 'cooling off' period to 2 years instead of the proposed 4 years. These interest groups were also successful in their lobbying efforts in limiting the restrictions to partners and key senior members of the audit team. This view was also shared by the Legal Practitioners and the External Commentators.	The Corporations Act prohibits a person from becoming an officer of an audited body for 2 years where the person ceases to be a member of an audit firm or director of an audit company and was a professional member of the audit team for the audit. The Corporations Act defines 'professional members of the audit team' as any company auditor who conducts the audit and any other person who is in a position to directly influence the audit outcome. The specified 'cooling off' period and the restrictions applying to partners and key senior members of the audit team are consistent with ideal auditor independence as these are envisaged to strike an appropriate balance between promoting auditor independence and not unduly impeding audit professionals joining companies and bringing with them valuable financial expertise.	No amendments required.

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
5	*Financial Relationships* *The Government will amend the law to impose new restrictions on financial relationships. This will cover investments in audit clients and loans between an audit client, and the auditor or the auditor's immediate family.*	The Big 4 Firms were satisfied with the guidelines contained in the accountants' ethical code of conduct and did not believe it was appropriate for the Corporations Act to introduce further restrictions on financial relationships in addition to that imposed by professional standards. They recommended that the Corporations Act simply referred to the guidance developed and issued by the profession. The External Commentators also shared the same concerns as the Big 4 Firms.	The Corporations Act currently introduces further restrictions on financial relationships and does not replace the definition of immediate family member with that adopted overseas that was spouse and dependents.	Unsuccessful lobbying. No amendments required.
6	*Non-Audit Services* *The Government will*	The Accounting Associations, Big 4 Firms, Middle Tier Firms and Managers of Companies	The Corporations Act requires listed companies to disclose in their respective company's	Unsuccessful lobbying. No amendments required.

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
	implement a series of measures to deal with non-audit services. It will:- *Amend the law to require mandatory disclosure in the annual report of fees paid for the categories of non-audit services provided*. *Amend the law to require a statement in the annual report of whether the audit committee is satisfied the provision of non-audit services is compatible with auditor independence. This disclosure would include an explanation as to why the non-audit services referred to in F1, if contracted, do not compromise auditor independence*.	(Producer Group) believed the threats (the inclusion of a list of non-audit services) were appropriately defined in the accountants' ethical code of conduct and this proposal should require adherence to the code. The suggestions of the Public Investors and the External Commentators were also disregarded.	annual report all non-audit services that have been provided. This includes details of the amounts paid or payable for the non-audit services.	

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
7	*Auditor Rotation* *The Government will make audit partner rotation compulsory after 5 years. The new requirement will apply to the lead engagement partner and the review partner. To maintain continuity of knowledge, the appointment of these partners could be staggered.*	The Accounting Associations, Big 4 Firms, Middle Tier Firms, APPC, Accounting Professional & Ethical Standards Board Limited and the Financial Reporting Council were successful in their lobbying efforts for the audit engagement partner and audit review partner rotation period to increase from 5 years to 7 years. This was not supported by the Small Firms, Legal Practitioners and the External Commentators.	The Corporations Act permits an individual auditor who has acted as external auditor for the listed company for 5 successive years to continue to act in that capacity for up to a further 2 years provided requirements are satisfied in relation to the safeguarding of audit quality and auditor independence. The current requirements provide a practical solution which attempts to address auditor independence whilst at the same time seeks to avoid imposing additional financial burden on these companies. The stipulated auditor rotation period achieves significant cost savings as compared to compulsory yearly audit firm rotation which results in the enhancement of the economic needs of the shareholders of these companies, being the primary users of accounting information. The stipulated auditor rotation period is consistent with internationally	No amendments required.

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
			accepted best-practice as contained in the accountants' ethical codes of conduct and other international examples which have showed a preference for 7 years in jurisdictions other than the US.	
8	*Auditors' Duties Expanded* *The Government will amend the law to expand matters which auditors must report to ASIC to include any attempt to influence, coerce, manipulate or mislead the auditor*.	The Accounting Associations, Big 4 Firms, Managers of Companies (Producer Group), ASX and the Auditing & Assurance Standards Board were of the view that expanding the matters to be reported to include 'attempts to influence, coerce or manipulate' would be difficult to apply in practice for various reasons. This proposal was also rejected by the Legal Practitioners and the External Commentators.	The Corporations Act requires individual auditors conducting an audit to notify ASIC within 28 days after they become aware of any circumstances that amount to an attempt, in relation to the audit, by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit.	Unsuccessful lobbying. No amendments required.

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
9	*Streamline Auditor Discipline Arrangements* *The institutional arrangements for taking disciplinary action against registered company auditors will be strengthened to (amongst other things) provide a majority of members of the CALDB, with appropriate skills, who are non-accountants*.	The Accounting Associations, Big 4 Firms, Middle Tier Firms, Managers of Companies (Producer Group) and the Companies Auditors & Liquidators Disciplinary Board were generally successful in their lobbying efforts to ensure that the composition of the CALDB is not restricted to a majority of non-accountants. This view was also shared by the External Commentators	The ASIC Act does not prohibit the composition of the CALDB to consist of a majority of accountants. Ideal auditor independence means that the composition of the CALDB consists of at least a majority of non-accountants.	The ASIC Act should be amended to accommodate the technical knowledge requirement and should ensure that the composition of the CALDB consists of a majority of non- accountants.

No.	RELEVANT PROPOSALS	FINDINGS FROM THE APPLICATION OF PRIVATE INTEREST THEORY	OUTCOME	PROPOSALS FOR LAW REFORM (WHERE APPLICABLE)
10	*Shareholders and Investors Advisory Council* *The Government will establish a Shareholders and Investors Advisory Council, to be chaired by the Parliamentary Secretary to the Treasurer, which it will consult on all disclosure-related reforms to ensure they meet the needs of retail investors.*	The Accounting Associations and the Managers of Companies (Producer Group) were successful in lobbying against the existence of the Shareholders and Investors Advisory Council. The Legal Practitioners also objected to this proposal. On the other hand, this proposal was supported by the Public Investors.	The Shareholders and Investors Advisory Council no longer exists. Retail investors now no longer have the opportunity to investigate disclosure-related concerns that relate to auditor independence in order to ensure that these concerns are consistent with ideal auditor independence.	The government should create a new Shareholders and Investors Advisory Council. This can be specifically designed to protect and promote the interests of retail investors. The audit committee can be used as a forum for retail investors to voice their auditor independence concerns. Amendments to the ASX Corporate Governance Principles can support this.